



Reforming RBS

Local banking for the public good



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Summary

We have a unique opportunity to rebuild public trust in the UK banking sector. Restructuring RBS into a network of local banks with a public service mandate and supervised by citizen stakeholders would transform the face of UK domestic retail banking and bring significant economic benefits.

The total price paid by taxpayers for their majority stake in RBS since it was rescued from bankruptcy by a large injection of public funds in 2008 has now exceeded £45.5 billion. With questions over the future of RBS placing the public interest at stake, the persistent assumption that the bank should be returned to the private sector deserves greater consideration, scrutiny, and debate.

We question whether privatisation is really the best strategy for the future of RBS, and consider an alternative that would create greater economic benefit for the country as a whole, including taxpayers. There are considerable uncertainties about the amount of money that could be raised by the government through a sell-off, how soon it could be raised, and whether it would be possible to avoid making a loss on the sale. But these are not the only grounds on which to question the Chancellor of the Exchequer's intention to return RBS to private ownership as soon as possible.

Our analysis shows that turning RBS into a local stakeholder banking network will deliver significant economic and social benefits.

Through comparisons with public savings banks in Germany and Switzerland, we estimate UK GDP would already have benefited from an immediate boost of £7.1 billion, and an additional £30.5 billion over three years had localisation taken place in 2008.

Together with the other benefits of the proposal, this far exceeds the £700m annual savings in government interest payments that would result from using the estimated £40 billion proceeds from privatisation to repay the national debt.

The key benefits of restructuring RBS into a network of local stakeholder banks would be:

- **Increasing credit for the real economy.** Local stakeholder banking networks focus more on small and medium enterprise (SME) lending and they increased lending to businesses and households during the recession while large commercial banks withdrew credit from the economy.

- **Protecting jobs and growing their number and quality.** Investment in higher staff-to-customer ratios by local stakeholder banks with consequent tax revenues, saved welfare, and benefit costs and social benefits.
- **Improving the diversity and resilience of the UK banking system.** Offering greater protection to the economy against future economic shocks.
- **Promoting financial inclusion** through access to a current account for all UK citizens, and maintenance of universal branch coverage across the UK.
- **Rebalancing the economy.** Increasing investment and economic development in regions outside London, as well as greater financial support for local social, cultural, and sporting activities

The bank's current strategy of simplifying its business and focusing on UK retail and commercial banking has set the right direction of travel. We set out the steps needed to complete the journey, including withdrawing from international and investment banking markets, and the potential benefits of doing so for the UK economy.

The UK stands out among comparable countries for its lack of diversity in banking sector ownership. The building society sector is the only significant alternative to commercial banks owned by shareholders, but they do not serve the SME market.

Through an illustration of what an alternative might look like for one city and one county in the UK – Bradford and Cornwall – using a comparison with existing public interest banks in Germany, we demonstrate a number of the potential benefits of local stakeholder banks.

The financial crisis of 2008 rapidly eroded public trust in UK banking institutions. Establishing RBS as a genuinely local bank with an explicit mandate to serve the public interest, and to include citizens as stakeholders on its supervisory board, would go a long way to rebuild trust in the banking system as a whole. RBS could have a bright future – as a citizens' bank built on principles of accountability and transparency.

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1. Introduction – the unanswered question

From the moment that RBS was rescued from bankruptcy by a large injection of state funds, it has been predetermined that it should one day be returned wholly to the private sector. Such an important decision deserves greater consideration, scrutiny, and debate. Privatisation is not the only answer. The real question is which alternative for RBS would yield the greatest long-term social and economic benefit for Britain.

The government owns significant proportions of two of the UK's largest banks. As a result of the emergency bail-out package in October 2008, the British public effectively acquired shareholdings of 82% of RBS and 43% of Lloyds. In 2013, the Chancellor of the Exchequer set out three objectives for how it would deal with these stakes going forward.¹

1. Maximise the ability of the banks to support the British economy.
2. Get the best value for money for the taxpayer.
3. Return the banks to private ownership as soon as possible.

There is confusion at the heart of these objectives. If the question is how to serve the British economy and taxpayers, then privatisation is not the third objective but an answer to the first two.

But it is only one possible answer. The unanswered question is whether privatisation is really the best strategy for RBS, or whether there is an alternative that will create more economic benefit for the country as a whole, including taxpayers. That is the question we address in this report.

The government's holding in Lloyds was never a majority stake and sales of these shares are now underway. This should continue. We focus on RBS, in which the government has a majority controlling stake and therefore has many more options available.

1.1 Options for RBS

The government has always pursued the policy of selling its shares in RBS at the earliest opportunity. The logic is that banks work best when held in private hands, and that government ownership of banks always introduces inefficiency and market distortions. However, these are assumptions that are challenged by international evidence, as we examine later.

Variations of privatisation have been proposed² that give shares to the public rather than sell them to institutional investors, such as pension funds and hedge funds. This would spread the ownership and economic participation in future profits of RBS but it does not challenge the core presumption that the bank should be owned and run solely in the interests of private shareholders.

We examine an alternative approach that challenges this core presumption. The UK has very few locally focused banks in comparison to its major international competitors. This has profound implications for financial stability, for lending to the real economy, and for competition. It is also a fact that most banking systems, unlike the UK, have a mixed ownership structure with mutual and public banks competing with and complementing private shareholder banks.

Developing a significant local banking sector in the UK could take decades, as will improving the diversity of ownership. Restructuring RBS into a network of autonomous but collaborating local banks with a broader social mission, such as those that are prominent in Germany and many other countries, therefore represents a unique opportunity to transform the shape of UK domestic retail banking.

Three UK think-tanks – the New Economics Foundation (NEF),³ Civitas,⁴ and ResPublica⁵ – have called for this approach, and similar proposals were discussed in the debate on Scottish independence.⁶ Further research is required to establish the economic case for local stakeholder banks, how restructuring of RBS would be achieved in practice, and what the social and economic impacts might be. This report seeks to address these gaps.

1.2 Our research approach

In Section 2 we start by examining the case, both theoretical and empirical, for having a local stakeholder banking sector – a sector that the UK is exceptional in lacking. We challenge assumptions about the inherent superiority of private shareholder ownership and misconceptions about co-operative and public banks.

We then set out in Section 3 a vision for how RBS could be reformed as a local banking network with a public interest mandate, how this would refocus the bank's businesses, what scale the local banks would cover, and what the most appropriate ownership and governance structure would be to fulfil this new mission. We also deal with a number of significant practical issues presented by such a restructuring. We provide some illustrative case studies in Section 4 based on two German savings banks in the context of comparable cities and regions in the UK.

In Section 5 we evaluate the economic and social impact of transforming the shape of the UK banking industry in this way, compared with privatisation and relying on organic growth of local stakeholder banks. Section 6 concludes with a recommended process for implementing these proposals.

This report draws on a wide range of resources. It draws on previous NEF research on international comparisons of banking structures and adds more detailed reviews of Northern European countries where both significant commercial and local stakeholder banking sectors exist together with good central bank data; Germany, Switzerland, the Netherlands, and Scandinavia. The sections on the theory of market failure in banking draw on well-established academic literature and government inquiries. Calculations and valuations apply conventional methodologies the detail of which is set out in the technical appendices. The barriers that we discuss in Sections 2.4 and 3.5 are based on many conversations with UK politicians from all main parties, civil servants, and political advisers. We have made use of many expert interviews with representatives of organisations in the UK and overseas, and we offer our sincere appreciation and thanks to all those who gave their time and knowledge freely to support our research.

2. The case for local stakeholder banks

Market failures are endemic in banking, with some market segments suffering more than others from under-provision of banking and credit. The reasons for this are well established in theory and well documented in practice. A common response to this problem in other countries is a diverse and mixed banking industry, and in particular the presence of networks of local stakeholder banks complementing the large national and international shareholder banks that dominate the UK market.

One of the hardy perennials of the UK political and economic landscape is the lament that there is insufficient finance for small and medium size enterprises (SMEs). A number of enquiries and commissions into the subject have concluded that there is market failure in domestic banking. The most famous is perhaps the 'Macmillan gap' in SME finance identified by the Macmillan Commission of 1931,⁷ but subsequent enquiries – Radcliffe (1957–1959),⁸ Bolton (1971),⁹ and Wilson (1979)¹⁰ – all reached similar conclusions. The present government (2010–2015) has examined the question in a number of ways,¹¹ and yet net lending to businesses fell in 2014 for the fifth consecutive year.¹²

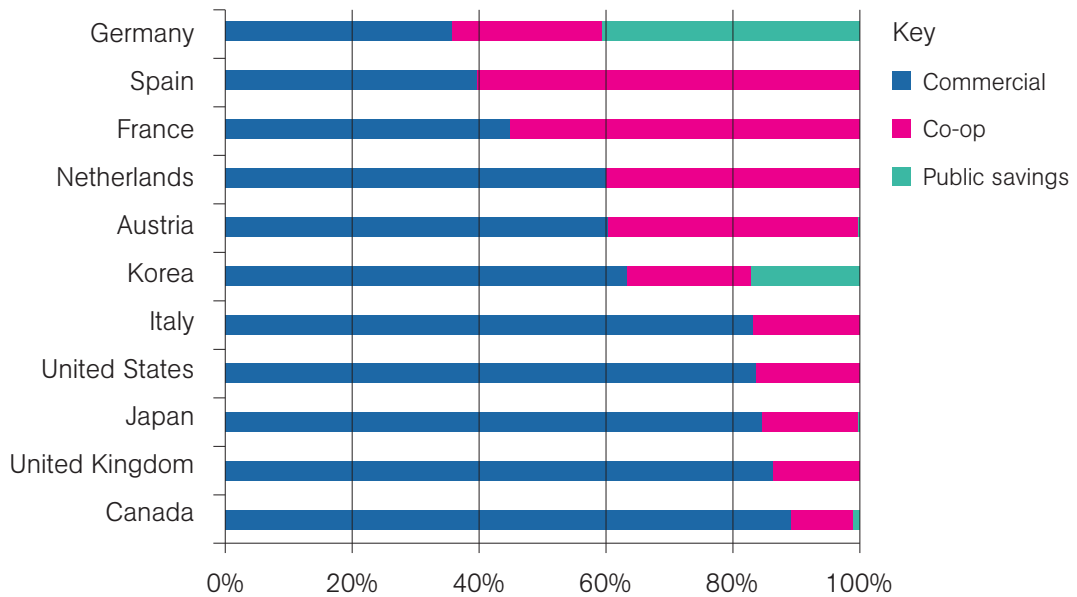
The only surprising aspect of this is that anyone should be surprised. There are sound reasons in economic theory why we might expect the provision of credit to SMEs to be sub-optimal from a whole economy perspective. And this is not the only failure likely to arise from the nature of the UK banking market. We examine these theoretical arguments in Section 2.2, before turning in Section 2.3 to the question of whether there is any evidence that alternative banking structures might do better.

The starting point is to understand that the structure of the UK banking system is quite unusual in comparison with our industrial competitors both in terms of the proportion of non-shareholder banks, and of the lack of local banks.

2.1 The UK banking system in international context

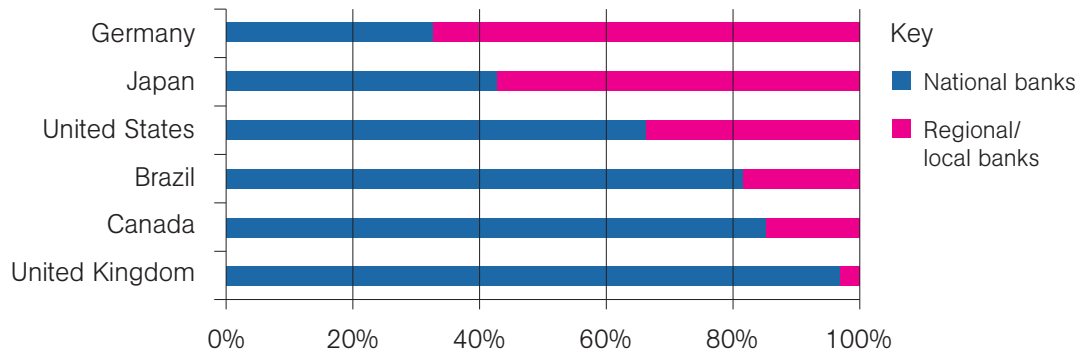
The UK has a very homogenous banking system in comparison to many other large economies, with regard to both ownership (Figure 1) and scale (Figure 2). The UK ranks poorly for diversity of ownership with the building society sector being the only significant alternative to commercial banks (owned by shareholders). Unlike co-operative banking sectors in many other countries UK building societies in general do not serve the SME market.

Figure 1. Banks' market shares of deposits by ownership type



Source: Consultative Group to Assist the Poor / World Bank¹³

Figure 2. Banks' market shares of deposits by geographic scale



Source: NEF calculations using central bank data, IMF research, banks' annual reports and data provided by industry trade groups

Although there are some key exceptions, in particular the USA, local banking sectors are often characterised by stakeholder ownership and governance – in other words the mission of the bank is not to maximise profits but to optimise returns to a range of stakeholders, including customers and the broader local economy.

The UK lacks such a local stakeholder banking sector, particularly in certain key markets. We use the term 'stakeholder banks' to include any ownership or governance structure that has a broader remit than simply to maximise returns to shareholders. The primary forms are co-operatives (including mutuals and credit unions), public interest banks, and socially orientated loan funds such as Community Development Finance Institutions (CDFIs).¹⁴

But why might this matter? The answer lies in the nature of the banking market and the presence of inherent market failures that are well grounded in economic theory and established by numerous empirical studies.

2.2 Theory – market failure and the need for diversity

Economics can demonstrate that, given certain assumptions about the world and given perfect conditions, markets should be the most efficient mechanism for allocating resources to maximise the production of goods and services.

However, perfect conditions never exist in the real world, and assumptions rarely hold true in practice – they are **at best** rough approximations to reality. So economics also has a number of ways of analysing why and when markets will fail to deliver the best economic, social, and environmental outcomes.

Some markets are more beset with market failures than others, and so it is important to understand the particular features of any given market before drawing conclusions about how best it should be structured. We examine the particular and unusual dynamics of the market for credit, before considering other banking services, such as current accounts, and investment and insurance products.

In addition, it is also important to understand the dynamics of the system itself. Insights from complexity science, when applied to financial systems, are drawing attention to the importance of certain characteristics for the resilience of the system as a whole. When describing economic systems, we can think of resilience as meaning that the system can cope with, and adapt to, major shocks while continuing to maintain its core functions and to deliver positive societal outcomes. We return to the question of economic system resilience later on.

2.2.1 The market for credit

Banks have a unique economic role that is quite unlike the provision of any other product or service – they create new money.¹⁵ The market for credit therefore has an economic significance well beyond most markets and at the same time gives rise to particular forms of market failure.

As the Bank of England recently stated, private banks create 97% of the money supply.¹⁶ When a bank makes a loan, it creates both an asset (the loan) and a transferable liability in the form of a newly created deposit (money) which can be used to settle transactions. When a loan is repaid, the corresponding deposit is cancelled so that at any one time the money supply is determined by banks' net lending. This means that banks' decisions about **whom** to lend to, and how much to lend, play a key macroeconomic role.

Recognising the importance of money or, more precisely, credit creation, British and European monetary authorities practised formal and informal credit guidance and controls on domestic banks for most of the period from 1945 to 1970. This involved a range of practices including placing ceilings or quotas on loans to particular sectors whilst encouraging lending to other sectors believed to be beneficial for the economy, including export-focused sectors, construction, and infrastructure via subsidies or more lenient reserve, capital or liquidity requirements.^{17,18}

Since the 1970s, credit creation and allocation have been increasingly deregulated with a view that greater efficiency could be achieved via free market competition in finance. Credit was impacted only indirectly via central bank influence of the price of credit in pursuit of inflation targeting. In the credit market, the price of credit is the interest rate that the borrower must pay plus any charges and fees associated with the loan. If the credit market is in equilibrium, there should be an 'equilibrium real interest rate' at which both lender and borrower will be satisfied, all loans will be granted and the credit market will clear.¹⁹ Monetary authorities should intervene only to ensure the equilibrium real rate of interest is achieved; this can be done most effectively by targeting inflation.²⁰

This theoretical framework makes important assumptions: agents in the market behave rationally and have comparable preferences for goods and services; they have perfect information and foresight; and markets are competitive. In reality, it is hard to envisage how the market for credit could have such an equilibrium price.

First, the demand for credit in terms of quantity is not restricted in the same way as the demand for real goods and services. This is because access to money or purchasing power does not have the declining marginal utility associated with most commodities. Suppose you would like more pairs of shoes; eventually you will simply run out of space for shoes. The novelty from each new pair of shoes will begin to wear off and the pleasure gained from them will reduce.

Economists call this declining marginal utility; each additional pair of shoes adds less utility than the last and so you will be more likely to buy other things instead. However, having more money does not mean you can have less of something else. It just means you can have more of everything and anything. It is a means of acquiring all other goods and services and so the demand for credit, and hence money, appears far less subject to diminishing marginal utility.

Secondly, a borrower is always likely to have more information about whether they will be able to pay back a loan than a bank, particularly where business loans are concerned. Rather than perfect information, or any approximation to it, there is significant **asymmetry** of information between lender and borrower.

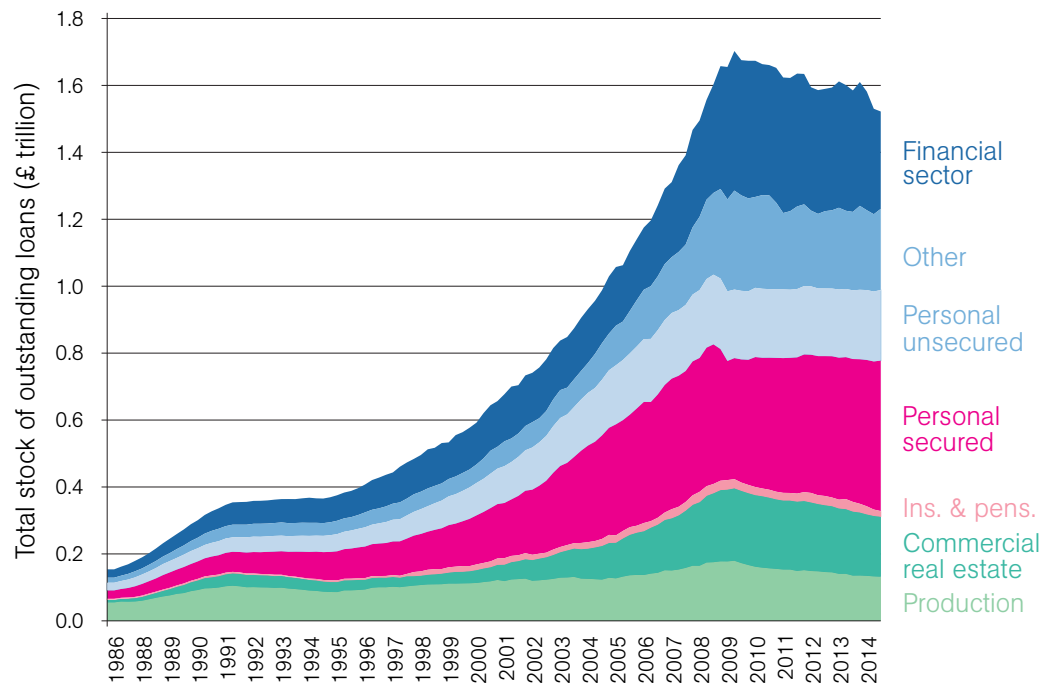
In addition, the **risk** associated with a loan is also asymmetrical. This particularly applies to businesses which have limited liability, meaning that if a business fails the owners will not be liable for outstanding loans. If there are no other assets against which the bank can secure the loan the bank potentially faces greater risk than the managers of the business. Where there is little 'hard data' – factual information that is recorded and verifiable – this adds to the bank's problems of assessing whether to allocate credit or not.

Given these factors, the rate of interest required to balance supply and demand would be excessively high and would result in adverse selection. Reasonable borrowers with wealth-creating projects that cannot generate sufficient returns to service such high-cost loans would fail to get credit.

In reality, it is more important for a bank to avoid loan defaults than it is to earn a higher rate of interest. As a result banks prefer to **ration** and thus independently **allocate** credit – even in the best of times.^{21,22} They lend to businesses they perceive as being low risk at below the true market rate of interest and exclude altogether – or quantity ration – lenders they perceive to be more risky.²³

An examination of lending by domestic UK banks since the mid-1980s shows how the deregulation of the UK banking sector has translated in to credit growth to different sectors of the economy (Figure 3). UK banks have increasingly favoured lending to other banks (financial intermediation) and for real estate (household secured and commercial real estate) over lending for working capital and investment that may support the SME sector. There has been a steady decline in the proportion of lending to production sectors, such as manufacturing, transport, construction, communication and retailing, in comparison to all other sectors.

Figure 3. UK bank lending by sector 1986–2014



Source: Bank of England²⁴

This structural bias has been made worse by incentives created by Basel III international capital adequacy regulations, which increase the cost of SME lending relative to property lending and purchases of financial securities.²⁵

In the UK, the Bank of England's research, which involves regular surveys of demand amongst businesses, suggests the supply side constraint has been stronger since the financial crisis and historical studies show similar evidence.²⁶ Two recent large-scale studies which examined individual loan application data and were able to control for the quality of firm, time of applications, general economic conditions, and monetary policy interventions, found robust statistical evidence of credit rationing.²⁷

In fact, SME financing has long been recognised as a systemic problem for the UK economy. Historical studies of the Victorian (1860–1914) period,²⁸ the inter-War period^{29,30} and the post-1945 period^{31,32} identify a ‘transaction’ over ‘relationship’ banking approach to corporate finance that discriminated against SME loans. In a detailed historical review of the 1944–1960 period, which incorporated reviews of internal and confidential bank documentation, Baker and Collins define the strategy as involving the maintenance of (1) a highly liquid asset base; (2) careful screening of applicants for loans to eliminate high-risk borrowers from the outset; (3) restrictive threshold requirements on collateral; (4) short-period loans; and (5) a requirement for only a minimum of detailed information on client’s business and involvement in the client’s business strategy.³³

This ‘transaction’ strategy is economically rational from banks’ perspectives. It reduces risk and maximises profitability by significantly reducing the transaction costs associated with lending. It has endured despite repeated government efforts to intervene and stimulate SME lending.

Rather than criticise commercial banks’ practices, enforce structural changes, or set up competitors, invariably the approach in the UK has been to underwrite or subsidise SME lending by existing commercial banks. This includes the Small Firms Loan Guarantee Scheme introduced in 1981 following the recommendation of the Wilson Committee, up to the range of schemes in place today.

In Section 2.3 we review how other economies have a different approach to solving this problem. They have a range of different types of banking institutions with different organisational objectives and incentives for longer term productive lending, including to SMEs.

2.2.2 Other banking services

We previously set out how asymmetric information leads to market failure in the allocation of credit – the business borrower has more information than the bank. The same problem causes market failure in various banking services and products, but in this case because the bank knows much more than the customer.

For customers to wield market power over suppliers, they need to understand perfectly what they are buying. This is more difficult if all products are different – customers need to be able to compare like with like. Second, customers need to have full information about the features of the product and all the related and potential costs associated with it. Third, customers must behave rationally. Fourth, the cost of comparing and switching products, including the customers’ time and effort, must be low. Finally, the product must be something the customer buys repeatedly and frequently so they can learn from previous experience and switch to the best products and suppliers.

No one expects to find these textbook conditions in real life, and a lack of perfect information, rationality, and competition does not undermine the rationale for markets. But we must also not gloss over serious flaws. Not all markets are equal. The conditions described above apply rather well to getting your hair cut. Unfortunately they apply very badly to banking services.

Consider payment protection insurance, probably the biggest UK misselling scandal of all time.³⁴ This product is purchased very infrequently giving customers no opportunity to learn from past bad experiences. Information is also highly imperfect and one-sided because the seller enjoys an information advantage over the buyer. Finance is a complicated discipline and banks have substantial expertise that consumers often severely lack.

In such conditions, customers are ripe for exploitation. Competition simply becomes a race by banks to see who can exploit the most. The cure for misselling is not competition, but structural and regulatory reform – regulation to improve transparency and punish misselling, and structural reform to change the incentives of bank staff away from maximising profits and towards maximising customer benefit instead.

Even if perfect information did exist in banking markets, customers are not perfectly rational and banks' marketing departments have become adept at taking advantage of this. Take personal current accounts, for example. Comparison is made difficult by banks' bundling current accounts up with other services such as mobile phone and travel insurance, often as a deliberate marketing strategy.³⁵ Overdraft charging structures are difficult for customers to understand and too complex to compare readily between banks.³⁶

Other banking products exploit well known irrational traits in consumer behaviour.^{37,38,39} Teaser rates, where an attractive initial interest rate changes to an uncompetitive one after an introductory period, are a widespread example of banks' exploitation of human frailties.

In fact, RBS has shown leadership on this issue, pledging to end the use of teaser rates for credit cards and savings products so that all customers are treated the same.⁴⁰ Regrettably, no other major UK banks have followed this commendable example of good practice.

As a result of these inherent market failures, banking is better viewed as a service based on trust, much like law, accountancy and medicine, where non-expert and potentially vulnerable clients have to rely on the integrity of the professionals who serve them. Although such services are often delivered as a commercially viable business, they rely on an organisational mission that places integrity and customer service before profits.

2.2.3 Resilience and diversity

The term 'resilience' is gaining currency among financial policymakers and regulators. The Financial Policy Committee has an explicit remit to protect and enhance 'the resilience of the UK financial system'.⁴¹ Official documents on Basel III repeatedly describe its goal as being a more resilient banking system.⁴²

Yet there is still not an agreed understanding of what financial system resilience means, or of the key factors which affect it. In previous work on economic resilience carried out for the Friends Provident Foundation, NEF has defined resilience not in terms of the system's ability to return swiftly to 'business as usual' – but in terms of its ability to fulfil its social function and to adapt to changing circumstances.⁴³ This definition emphasises that we must think about system resilience in the context of that system's purpose.

Resilience thinking and the disciplines it draws on, such as ecological science and complexity theory, pose a fundamental challenge to conventional neoclassical approaches to the financial system. For example, neoclassical economic thinking privileges efficiency, but we need to recognise that there is often a trade-off between efficiency and resilience. Neoclassical economics treats individual economic actors as its unit of analysis, but we need to recognise the importance of connections between actors: a system is more than just the sum of its individual parts.

Since the financial crisis of 2008, research by academics and regulators has sought to understand how the stability and resilience of the financial system might relate to its structure and characteristics. One key finding is that diversity is a critical factor in system resilience – not just the number of banking institutions but their diversity of location and scale, diversity of ownership, and diversity of business models.⁴⁴

As we saw in Section 2.1, the UK's banking industry stands out from international competitors for its lack of diversity. In short, we are guilty of putting all (or at least most) of our eggs in one basket – relying on one particular business model to provide a large range of financial services for the entire economy. In contrast, having a range of different business models, organisational structures, and risk appetites means that one type of banking institution may be able to step up lending when other types are struggling to lend at all.

This is one aspect of the performance of local stakeholder banks that we examine in the next section.

2.3 Evidence – the benefits of local stakeholder banks

We define stakeholder banks as any bank that serves a broader range of stakeholders than simply delivering financial returns to shareholders. They generally have the following three characteristics:

- They balance social and financial objectives.
- They serve specific regions or markets.
- They collaborate in networks to achieve economies of scale.

In some cases, such as some CDFIs and credit unions serving very economically disadvantaged markets, they might not aim to make a profit. The majority of credit unions and all co-operatives and public banks, however, are run on commercial lines with a financial mission to make a profit and deploy their capital prudently. They expect their loans to be repaid.

An important further characteristic of local stakeholder banks is the network structure that enables them to achieve the advantages of scale enjoyed by large commercial banks. This tactic has proven so successful that almost all continental European cooperative and public banks now exist as part of large networks.⁴⁵

These networks are generally coordinated by a central institution which enables them to achieve economies of scale in a wide variety of activities, including access to the payments systems and interbank markets, systems and product development, public relations, marketing, risk and liquidity management, training programmes, and lobbying efforts. Some central institutions also help coordinate intra-network deposit guarantee schemes, which help increase stability and confidence within the group, and should mean that local banks are less likely to have to turn to nationally run deposit guarantee schemes. Because other banks within the network will provide support if any single institution gets into trouble, the credit-worthiness of each individual institution is improved. Not only does this enable the member institutions to access funding at reduced costs, but it also encourages dialogue, collaboration, and mutual monitoring to ensure adherence to prudent banking.

How do such local stakeholder banking networks perform?

2.3.1 SME lending

Local banks can maintain intimate knowledge of local people and the local economy. Evidence suggests that they are better than commercial banks at seeking and assimilating the 'soft' information needed to holistically assess the prospects of small firms. This is how they overcome the asymmetric information market failure we discussed in the previous section.^{46,47} In contrast, large banks in search of profits and cost savings have relied more heavily on centralised credit scoring than on local relationship banking.^{48,49}

Large banks also appear to lend proportionally less to SMEs than smaller banks.⁵⁰ For example, in 2010, local cooperative banks had a significantly larger share of SME loans than their overall market share in Austria (46% of SME loans, compared with 33% of all loans), Germany (28% vs 17%) and the Netherlands (43% vs 29%).⁵¹ Credit unions in Canada have 17% of the SME lending market, despite holding only 5% of total banking assets,⁵² and they have nearly doubled their share of the SME market over 20 years.⁵³ SMEs report that they value the lower turnover of branch managers than at large commercial banks, as this allows the formation of long-term relationships and understanding.⁵⁴

As a result, local banks are the powerhouses of SME lending in many countries. For example, 80% and 58% of medium and small Swiss enterprises, respectively, bank with their local cantonal bank, and 75% of German SMEs bank with their local Sparkassen.⁵⁵

In a similar vein, local Sparkassen also outperform commercial banks at long-term lending to domestic enterprises. For example, in 2012, German commercial banks provided 46% of short-term lending to domestic enterprises compared with 33% from local Sparkassen. However, commercial banks provided only 20% of long-term lending compared with 45% from Sparkassen.⁵⁶

Empirical studies in Italy⁵⁷ and Germany⁵⁸ found that local cooperative banks and savings banks help reduce 'capital drain' to urban centres and thus regional inequality, most probably because of their strong SME lending. Preventing such a capital drain can help create jobs and encourage people to stay in their local area, rather than having to migrate to economic centres to look for work.

2.3.2 Branch networks

Local banks also generally provide more extensive branch networks than larger banks. For example, local cooperative banks have increased their share of European bank branches over the past 15 years from just under 25% to over 28%.⁵⁹ Where commercial banks have been closing down branches to increase cost efficiency in the face of use of online banking services replacing branch visits, local cooperatives have been able to prioritise maintain good branch access for all their customers.

Given the rise in digital banking and the reduced demand for branch services, are larger commercial banks simply being quicker to react to market forces? Perhaps, but branch services are still essential for small businesses and individuals who are unable to access digital services or need more personal assistance. Branches are also crucial when it comes to maintaining close face-to-face relationships with customers. The fact that local banks target a lower return on equity enables them to keep more extensive branch services available. This is perhaps best illustrated by the location of local bank branches in relation to large banks.

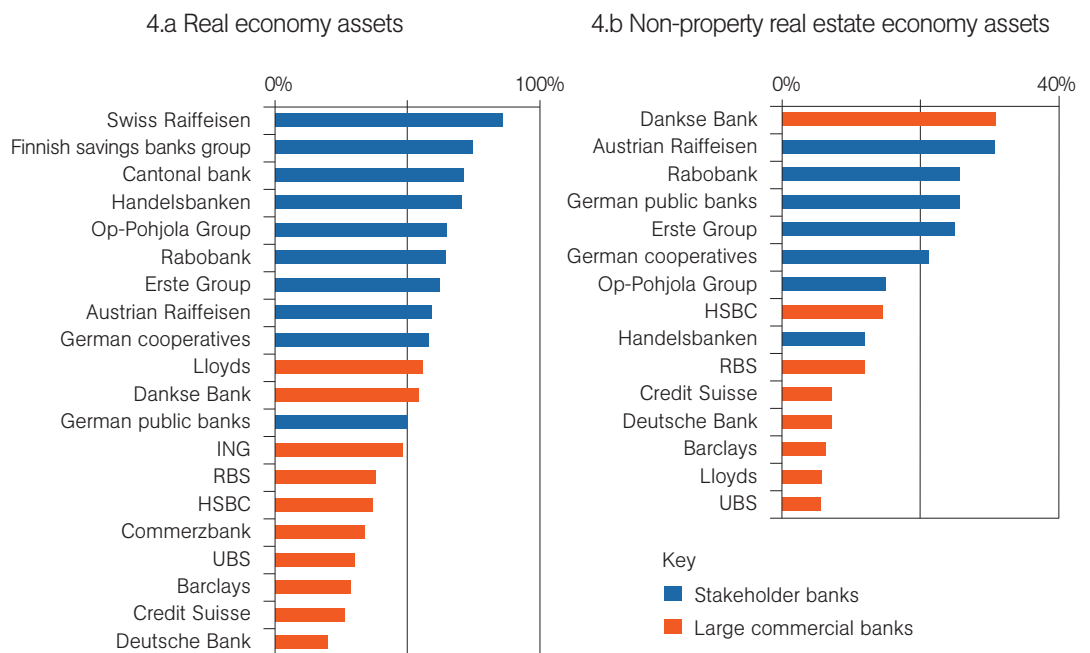
Local banks frequently concentrate their branches in more sparsely populated areas that are neglected by larger banks. For example, 33% of Austrian commercial bank branches are in Vienna compared with only 3 and 8% of the branches of the country's two local cooperative networks. These networks base a third of their branches in rural locations, compared to 11% of the commercial banks' branches.⁶⁰ Similarly, commercial banks in France concentrate in urban areas, whereas local French cooperatives typically locate between 25 and 33% of their branches in sparsely populated areas.⁶¹ In Canada, 38% of the communities served by Canadian credit unions have no other financial institution.⁶² Finally, Australian credit unions have been buying the branches in rural communities that commercial banks have closed down.⁶³

2.3.3 Applying balance sheets to the real economy

We examined 20 banks in northern European countries which have a balance between large shareholder banks and local stakeholder banking networks. As shown in Figure 4, local banking networks are much more focused on traditional high-street banking including lending to businesses and households rather than investment activities and lending to other financial companies. For example, local stakeholder banks devote 66% of their balance sheets to high-street banking and only 15% to trading in financial derivatives. In contrast large commercial banks invested only 37% in the high-street lending and 39% into derivatives trading.

A similar picture emerges if we strip out the effect of property loans, both commercial real estate and domestic mortgages, to pinpoint lending to businesses for productive investment and households for consumption both of which directly drive demand in the local economy. Local stakeholder banks typically devote twice as much of their balance sheet to such productive real economy lending than their larger counterparts (an average of 22% vs 11%).

Figure 4. Proportion of balance sheets applied to real economy lending and investment



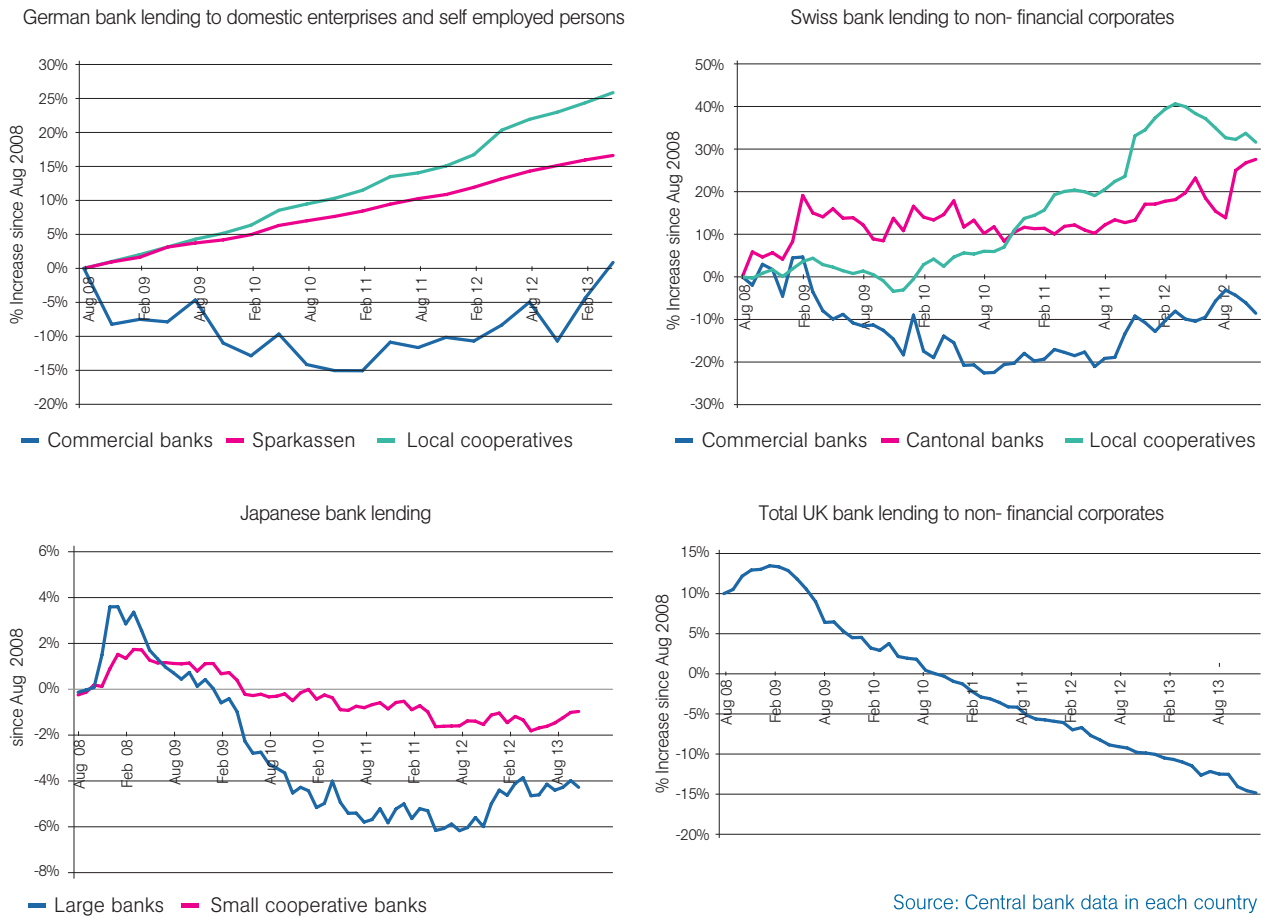
Source: 2012 Company Accounts and NEF calculations

2.3.4 Steady credit expansion

After the financial crisis, local banks in many countries stepped-up lending and so mitigated the fallout from the collapse in lending from larger banks (Figure 5). In contrast, the UK, which does not have a significant local banking sector, experienced a collapse only in overall bank lending.

This is a testament not only to the more prudent, traditional activities associated with local banking, but also to the network model itself. This helps small banks to overcome their lack of diversification of activities, funding, and geography and improve the resilience of the local banking network as a whole to economic shocks.

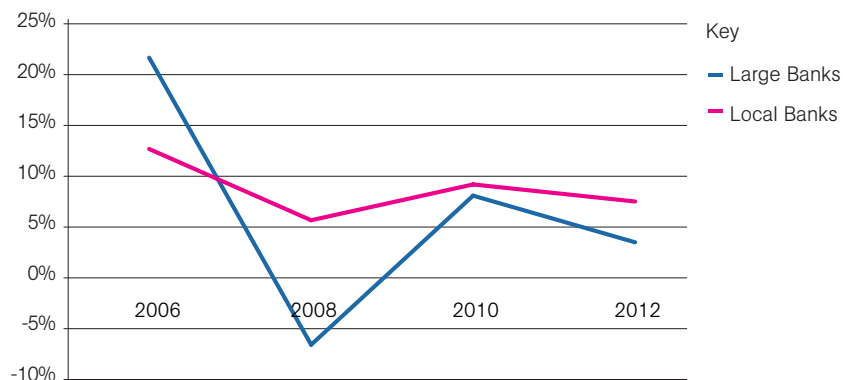
Figure 5. Comparison of credit growth between large commercial banks and local banking networks



2.3.5 More stable financial returns

Local stakeholder banks delivered more stable returns on equity on average than the large commercial banks in our northern European sample. Although large banks delivered much higher returns in 2006 at the height of the global credit boom, they also crashed down to much larger losses in 2008 as shown in Figure 6.

Figure 6. Average return on equity for large vs local banks



Source: NEF calculations from central bank data

Local banks' return on equality were much more likely to be within the range of 5 to 15% over the cycle and had much lower variability of returns as shown in Table 1. In fact, when taking an average over the cycle, the local stakeholder banking network delivered higher average returns on their equity than their large commercial counterparts despite (or perhaps because of) their rarely ever achieving a return on equity over 15%.

Table 1. Comparison of return on equity of large vs local banks

Return on equity							
Large banks	2006	2008	2010	2012	AVG	STDEV	Country
Credit Suisse	27.5%	21.1%	14.4%	3.9%	16.7%	8.7%	Switzerland
UBS	23.9%	-59.1%	18.0%	-5.2%	-5.6%	32.7%	Switzerland
HSBC	15.7%	4.7%	9.5%	8.4%	9.6%	4.0%	UK
Danske Bank	17.5%	1.0%	3.6%	3.7%	6.5%	6.5%	Scandi
Deutsche Bank	19.5%	-11.1%	5.5%	0.4%	3.6%	11.0%	Germany
Lloyds	24.4%	15.8%	-0.7%	-3.1%	9.1%	11.4%	UK
Barclays	24.7%	16.5%	6.8%	7.8%	14.0%	7.3%	UK
ING	23.5%	-2.1%	6.3%	5.2%	8.2%	9.4%	Netherlands
RBS	18.5%	-50.0%	13.0%	9.8%	-2.2%	27.8%	UK
Commerzbank	21.5%	-2.6%	4.5%	4.1%	6.9%	8.9%	Germany
Average	21.7%	-6.6%	8.1%	3.5%	6.7%	12.8%	

Local banks *	2006	2008	2010	2012	AVG	STDEV	Country
Swiss Raiffeisen	10.3%	7.3%	7.0%	6.2%	7.7%	1.6%	Switzerland
Op-Pohjola Group	13.7%	4.1%	6.8%	7.0%	7.9%	3.5%	Finland
Finnish savings banks group	16.8%	1.8%	12.0%	8.5%	9.8%	5.5%	Finland
Handelsbanken**	17.1%	14.7%	12.9%	14.7%	14.9%	1.5%	Scandi
Cantonal banks	12.5%	7.2%	9.6%	9.0%	9.6%	1.9%	Switzerland
Rabobank	10.1%	9.7%	8.6%	5.6%	8.5%	1.8%	Netherlands
Austrian Raiffeisen	18.4%	7.0%	10.5%	5.8%	10.4%	4.9%	Austria
Erste Group***	13.7%	9.6%	6.7%	3.8%	8.5%	3.7%	Austria
German cooperatives	6.9%	0.1%	13.0%	13.5%	8.4%	5.4%	Germany
German public banks	7.3%	-4.8%	4.9%	1.0%	2.1%	4.6%	Germany
Average	12.7%	5.7%	9.2%	7.5%	8.8%	7.8%	

Key

20.0%	above 15%	10.0%	between 5 and 15%	3.0%	below 5%
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Notes

* Central institutions are included within figures for local banking networks. For example, 'German public banks' includes Sparkassen, Landesbanken and DekaBank.

** We have counted Handelsbanken as a local bank, because of its localised decision-making structure.

*** Austrian savings banks were subject to regional restrictions until 1979. Since then, they have expanded aggressively, in particular, into Eastern Europe.

It's also important to note that European cooperative banking networks were responsible for only 8% of the total losses incurred by European banks during the financial crisis,⁶⁴ despite holding a 20% market share.⁶⁵ In fact, two individual commercial banks, UBS and HSBC, posted greater individual losses than the entire European cooperative banking sector.⁶⁶ In addition, no European cooperative banking network needed to be nationalised.⁶⁷

In summary, more consistent and stable returns were achieved by local stakeholder banking networks than by large commercial banks, despite the higher exposure of local stakeholder banks to real economy lending, including SMEs.

2.3.6 An efficient distribution channel for national investment banks

The government established the new British Business Bank (BBB) to increase the supply of credit and other forms of finance to SMEs by providing products that reduce risk and increase the profitability of lending to this market. It will have £1 billion of new capital and will take over existing investments, giving it a total of £3–4 billion, which will be used to stimulate a total additional £10 billion investment in SMEs.⁶⁸

National investment banks, such as the BBB, exist in many countries and regions and generally operate one of two models for distributing their products – direct and indirect.⁶⁹

Examples of such banks that lend directly to SMEs include the Business Development Bank of Canada and the Japan Finance Corporation. The Canadian bank has 106 branches, and the Japanese bank has 153 domestic offices and two offices overseas. The BBB is not going to create a national branch network and will instead operate on the more common indirect distribution model.

The success of indirect distribution rests heavily on the effectiveness of local banking networks in distributing products to the end SME customer. Our research showed that in practice, rather than as a matter of policy, national investment banks work disproportionately more with local banks (Box A) than large national shareholder banks.

Box 1: How national investment banks work with local banks

KfW works with nearly every German bank. However, representatives of KfW explained to us that Sparkassen and local co-operative banks are 'very strong at SME lending due to their local structure'. So the majority of KfW's lending goes through these institutions. The precise breakdown, however, was not publicly available.

Among regional state banks in Germany, NRW.Bank said it does not discriminate against or favour any type of bank but it mostly works with Sparkassen, because German SMEs tend to use Sparkassen for their financing needs. Similarly, LFA Bavaria said that, while it is not allowed to favour working with one type of bank, it does most of its SME business with Sparkassen, because the latter dominate SME lending in Germany.

Box 1 (cont)

The Russian Bank for Small and Medium Enterprises Support works with 150 small and regional banks but with only two large commercial banks. The other large banks are less interested in SME lending and find it easier to access finance than smaller banks.

The Nordic Investment Bank (NIB) reported that it mostly lends to SMEs via smaller banks, such as public savings banks, although it does work with a few larger banks. Its representatives explained that local banks are particularly good at SME lending and place a strong emphasis on this market. It does not have a deliberate policy to favour local banks, however; they are just better suited to the financing and ultimate lending. For example, the NIB asks to see a credible pipeline of potential loans before it will extend a line of credit to a bank. During this process it looks at how well the bank's client base fits its mandate.

In short, SME lending through intermediaries tends to depend on an effective local (as opposed to centralised) banking sector. The BBB is highly unusual in pursuing an indirect distribution model in a banking system that has no significant local banking sector and this casts doubt on whether it can achieve its potential without major structural shift within the UK banking industry.

2.3.7 Local shareholder vs stakeholder banks – the US case

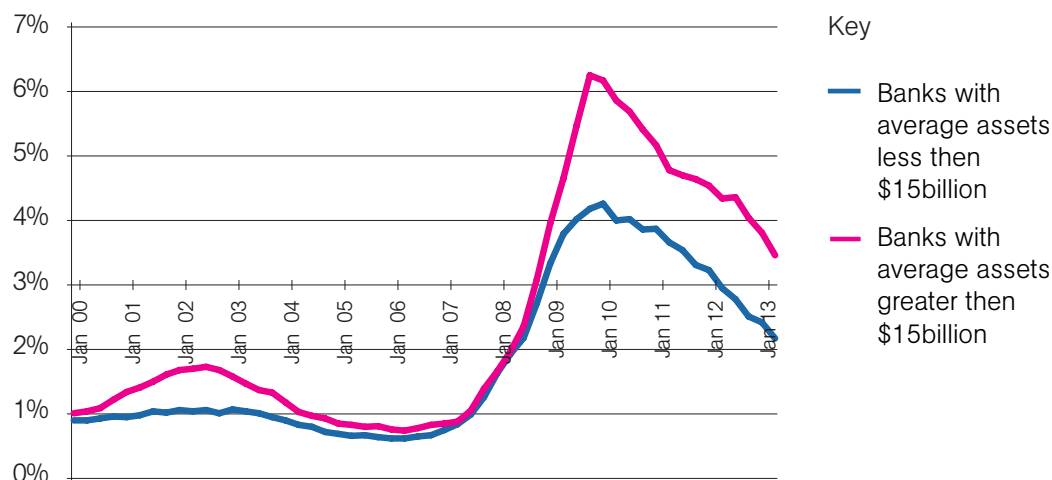
Is it necessary for local banks to have a social mission, or broader stakeholder ownership and governance, in order to deliver the benefits outlined in this section?

There are few examples of countries with thriving private local banking sectors but the USA does provide an important case for study. There are nearly 7,000 privately owned local banks in the USA.⁷⁰ Known as community banks, they have over \$1.2 trillion in assets and can be found all over the country.⁷¹

Community banks are characterised by local ownership, control, and decision-making. They focus on traditional high-street banking functions of lending and savings. They follow a **relationship** banking model where greater reliance is placed on soft information of the knowledge of local markets and individual borrowers. This contrasts with the **transactional** model of large national banks which rely on hard data – recorded statistics and facts about borrowers.⁷² This may account for the superior credit quality of community bank lending shown in Figure 7.

US community banks share other characteristics with European local banks. For example, they are responsible for providing most of the bank branches in many of the more rural states. While providing only 14, 21, and 21% of the bank branches in California, Florida, and New York, respectively, they provide 81, 78, and 76% of the bank branches in North Dakota, Kansas, and Iowa, respectively.⁷⁴ In all, community banks are between three and four times more likely to locate offices in small towns and rural areas than large commercial banks.⁷⁵ They are also a significant distribution network for the US Small Business Administration, a national agency that plays a similar role to the BBB in supporting SMEs.

Figure 7. Loan losses of large vs small US banks

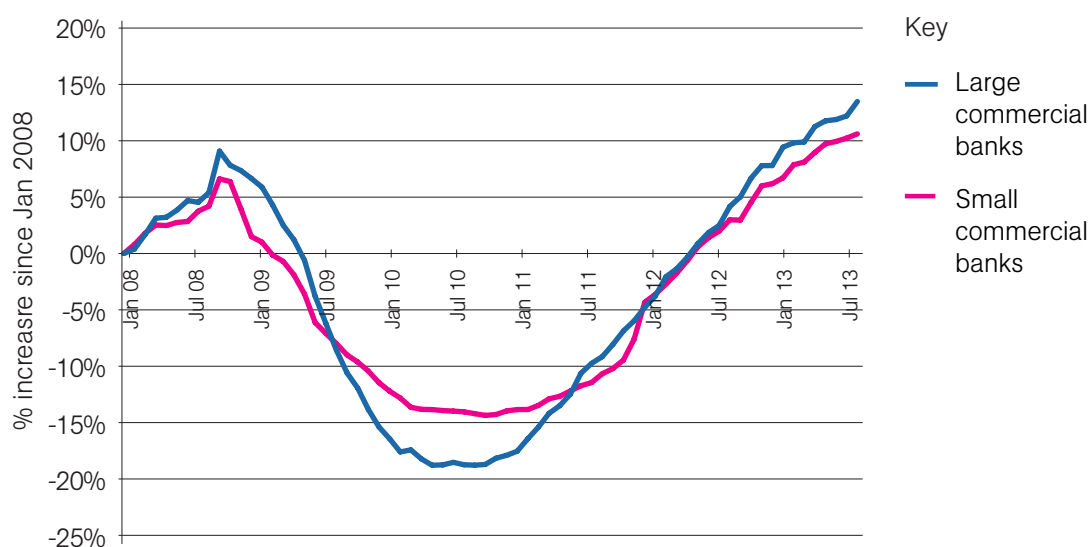


Source: NEF calculations from St Louis Federal Reserve Bank data⁷³

However, they did not match the performance of European local stakeholder banks other areas. As shown in Figure 8, while community banks displayed a slightly less extreme boom–bust cycle in non-bank lending during the financial crisis, the sector clearly did not provide the same counter-cyclical credit expansion exhibited in other countries.

The same pattern emerges when looking at profitability. Smaller US banks demonstrated a similar boom–bust cycle in returns on equity as their larger counterparts.

Figure 8. Comparison of credit growth between US large and small banks



Source: NEF calculations from St Louis Federal Reserve Bank data

2.4 Analysis – assessing the risks of local stakeholder banks

There is strong evidence from a number of countries that local stakeholder banks are an important constituent within banking systems that

- deliver more SME lending.
- have more extensive branch networks, which are important for ensuring financial inclusion.
- apply more of their assets to real economy lending.
- engage in steady credit expansion over the economic cycle.
- show steady and stable financial returns.
- employ an effective distribution channel for state promotional banks.

The common attributes of these banks are that they have a specific geographical focus and a combined financial and social mission.

Although the US sector is primarily one of private shareholder banks, it is significant that the USA embeds social obligations into its private banks through the regulatory structure of the Community Reinvestment Act. Private banks partner with and support CDFIs to ensure that all sections of the community have access to appropriate and affordable banking services. They are also often either privately or family owned, and therefore not driven by the need to satisfy capital markets' focus on short-term profit maximisation.

Without these pro-social features, private shareholder banks seeking to maximise returns on equity in the short term would be unlikely to perform the socially beneficial services of maintaining branch networks, providing universal access to transactional bank accounts, and cross-subsidising smaller less profitable loans with mortgage and larger corporate business.

This emphasises the benefits of having a social, or public interest, mission embedded in the constitution or organisational structure of local banks. But are there downsides to stakeholder banks, and would these be a sufficient reason to preclude co-operative and public ownership from consideration? We examine next a number of propositions that are often presented as arguments as to why banks should always be in private shareholder ownership.

Proposition 1: Stakeholder banks use capital inefficiently

It has been argued that the cooperative ownership structure holds back innovation and the optimum use of capital. This is because cooperative shareholders do not have a direct claim to capital. The cumulative profit of all members, past and present, is held in trust rather than distributed to owners leading some to consider it 'capital in dead hands'.⁷⁶ Similar considerations apply to public trust banks whose stakeholders, including local government, have no legal claim on the banks' capital.

On the contrary, the analysis in Sections 2.2 and 2.3 show that prudent management of scarce capital by stakeholder banks delivered steady and sustainable returns over the cycle. This, together with the scale of government support that was required to bail out commercial banks, has called into question the assumption that profit-seeking banks will by definition be the most efficient and economically productive.

A potential downside of stakeholder ownership models is the inability to raise large amounts of capital quickly by issuing shares on a stock market. Over the past few decades, this was considered to be holding back growth in the cooperatives sector and preventing it from competing with large commercial banks. In the UK, this was one of the main arguments for the demutualisation of many of the largest UK building societies in the 1990s. In many other countries, it prompted a move towards central institutions becoming so-called semi-cooperatives – i.e., banks that are owned by a mixture of members and shareholders.

The inability to raise external capital need not be a constraint, however, if the strategy of the bank is to grow its activities in line with its retained capital. Stakeholder banks do not pursue growth for growth's sake, and do not need to grow in order to attain the economies of scale provided by the network service model.

The primary reasons that commercial banks raise additional equity capital are to finance acquisitions or to rebuild core capital after suffering losses. The former is somewhat redundant to local stakeholder banks, and the latter has proved less of an imperative for stakeholder banks, as they generally made steadier profits throughout the financial crisis.

Furthermore, stakeholder banks' difficulties in raising capital should theoretically mean they are more careful about how capital is invested. If they make poor investment decisions, any resulting lost capital will be harder to replace than for a commercial bank. This is reflected in the higher levels of capital held by local stakeholder banks which helped them to avoid needing state support after the financial crisis to the same extent as the commercial banking sector.

Proposition 2: Stakeholder banks are operationally inefficient

Before the financial crisis, public banks came under heavy criticism for not being fully subject to the discipline of the market. As they are not solely focused on profit maximisation, they were criticised for not having a single, easily measurable target to drive efficiency in the organisation.

Stakeholder banks often have higher cost-to-income ratios than their commercial counterparts, but we cannot conclude that this reflects operational inefficiency. Instead it can reflect a different mix of business, with a greater focus on higher cost high-street banking activities, and a conscious decision to maintain staff numbers and branch networks at higher levels in order to deliver on the social mission of financial inclusion and good customer service. Table 9 in Section 5.2 for example, shows that stakeholder banks generally maintain a higher ratio of staff to customers than large commercial banks.

Proposition 3: Public banks distort competition

Public banks no longer have explicit local or national government backing other than insurance schemes which they pay for. For example, over 50% of Swiss cantonal banks pay a fee to compensate for guarantees from their regional government.⁷⁷

Nevertheless, many would still argue that such institutions also enjoy an unfair competitive advantage from *implicit* state backing, i.e., in reality, they would not be allowed to fail.

Research has shown that in the aftermath of the financial crisis, investors now assume that host governments will step in and bail out very large commercial too-big-to-fail (TBTF) banks if they ever get into trouble.⁷⁸ Lending money to a TBTF bank is thus deemed to be less risky than it would be without this implicit government backing. This translates into lower interest rates, which save banks enormous sums of money when they borrow. These savings are called the TBTF subsidy, and many commercial banks have benefitted to an extraordinary degree from such subsidies. For example, the four largest British commercial banks enjoyed a combined £38 billion TBTF subsidy in 2012.⁷⁹

This demonstrates that no special advantage accrues to public banks because of their ownership, but rather special advantage accrues to any bank that is systemically important, regardless of its ownership structure.

Proposition 4: German regional banks' losses discredit public banks

The seven Landesbanken – German regional public banks – suffered considerable losses during the financial crisis and this case has often been cited as proof that both public banks and regional banks are unsafe and inefficient.⁸⁰ They certainly provide lessons about appropriate ownership and governance structures and corporate objectives for public banks.

Landesbanken were founded after World War II as part of the post-War reconstruction effort with the objective of serving the domestic industrial sector with corporate banking, investment banking, wholesale banking, and international business and investment management. They also act as wholesale banks for local savings banks. For example, Landesbanken will invest Sparkassen's surplus deposits, and also help the local banks manage liquidity by, say, organising a liquidity loan from one Sparkasse to another.

Landesbanken are owned partially by regional governments and partially by Sparkassen. As a result, Landesbanken can technically be sold and, crucially, the German states as part-owners directly benefit from increased profitability and have a degree of control, including seats on the supervisory board.

During the period of banking liberalisation prior to the financial crisis, Landesbanken were viewed as inefficient institutions that competed unfairly with private sector banks. Their state guarantees were removed from 2001 and great pressure was put on them both by their regional state owners and other bodies, such as the European Commission, to increase their financial returns.

As a result, their mission changed. They became bigger, had a greater international focus, and stepped outside of their traditional expertise to invest in complicated, high-yielding financial products, such as mortgage-backed derivatives, which later turned out to be enormously over-valued leading to considerable losses during the financial crisis.⁸¹ Many Landesbanken were jointly bailed out by Sparkassen and the federal government and some were absorbed by the stronger Landesbanken.

The first lesson to be drawn is the importance of the distinction between the public trust model of the local Sparkassen and the state-owned model of the Landesbanken, where the danger of political interference is much greater. Secondly, public banks must be safeguarded against changing their mission to try to behave like their private sector counterparts and enter markets outside their core mission and expertise.

Proposition 5: The bankruptcy of Spanish savings banks discredits local banks

Savings banks in Spain, called Cajas, are private institutions that are legally classified as unowned foundations. They suffered huge losses as a result of the collapse in the Spanish property market and the deep recession that followed the financial crisis. Many banks failed, and following restructuring the number has reduced from 45 to 10. Seven savings banks were merged in 2010 to form a new entity called Bankia, which, just half a year later, was floated as a public company to raise capital from stockmarket investors. It required a further government bailout of €19 billion in May 2012.

There were three key reasons behind the failure of Cajas:

1. Political control

Although local governments did not own their local savings bank, they were usually heavily represented on the executive board of the local bank, responsible for overseeing day-to-day operations including lending policies and decisions. They sometimes comprised over 50% of the board, although this was capped at 50% in the early 2000s and 40% in 2010 due to complaints around excessive political interference.⁸² Political representation on the executive board is highly unusual, such influence typically being restricted to the supervisory board, which is only responsible for approving the overall strategy of the bank and holding the executive board to account for delivering the strategy. This poor governance structured enable local politicians to steer soft loans into pet vote-winning projects.

2. Deregulation and expansion

Cajas had their regional operating restrictions lifted in 1989. Prior to this, the banks were restricted to doing business within their local area. The lifting of the regional principle had two main effects. First, it prompted a wave of mergers and acquisitions, and the number of cajas decreased from 76 to 54 over the next 20 years.⁸³ As the banks grew in size, they became increasingly distant from local people and more profit focused, with their social function becoming less and less prominent.⁸⁴ Secondly, the savings banks started to compete with one another nationally, and entered new geographical markets outside their traditional expertise. Cajas had never developed central and regional institutions and there was no peer-supervision, unlike in the German Sparkassen joint-liability scheme.

3. Deregulation and changed business model

Restrictions on Cajas' activities were also lifted during the 1970s and 1980s, with the aim of allowing them to fully compete with commercial banks, for example, by allowing them to become 'universal banks', permitting both retail and investment banking activities. The savings banks' market share of deposits increased from 45% to 57% between 1991 and 2007, and the amount of credit they extended increased 12-fold, which increased their market share of the loans market from 33% to 49% over this period.⁸⁵

This expansion was funded through wholesale markets rather than the traditional conservative practice of funding loans with local savings deposits. This reliance on short-term funding unravelled during the credit crunch when the inter-bank lending markets dried up, which, combined with the collapse in the value of their property assets, pushed Cajas into insolvency in a similar way to Northern Rock in the UK.

The lessons to be drawn from the case of the Spanish Cajas are that corporate governance must guard against political interference in lending decisions, and that allowing, or indeed compelling, local savings banks to change their corporate mission to chase high growth and returns in new unfamiliar markets can be a recipe for disaster.

Conclusions – towards a more balanced banking system

There is a strong case that local stakeholder banks can be socially and economically beneficial, and that by contributing to a more diverse banking system they improve overall system stability and resilience.

Where local and public banks have failed, this does not amount to a case against local and public banks in general any more than the failures of Northern Rock, HBOS, and RBS suggest that we should have no national or international shareholder-owned banks. Instead, all these cases provide valuable lessons about best practice in ownership, governance, strategy, and business models.

What we need is a balanced domestic banking industry that includes a significant stakeholder banking sector alongside both existing international and national commercial banks, and new innovative business models entering the market, such as peer-to-peer lenders.

Expanding this sector in the UK cannot be ruled out on theoretical or empirical grounds. Therefore to fail to even consider broader options for the future of RBS would have to be viewed as the result of ideological prejudice rather than sound and careful economic reasoning.

In the next section we consider what an alternative future for RBS as a local stakeholder banking network might look like, and how it might be implemented in practice.

3. Reinventing RBS as a citizens' bank

RBS should be restructured into a network of local banks with a public service mandate to deliver the social and economic benefits observed in other countries. The bank's current strategy of simplifying its business and focusing on UK retail and commercial banking has set the right direction of travel. We set out the steps needed to complete the journey.

The key characteristics of local stakeholder banks set out in Section 2.3 are that they

- balance social and financial objectives.
- serve specific regions or markets.
- collaborate in networks to achieve economies of scale.

Embedding these characteristics into a reformed RBS would require some key changes that we now examine in this section. The essence is to focus more on UK local high-street banking, to follow a simpler and more conservative business model, and to balance social and financial objectives.

We consider the first two of these this to be in line with the new RBS strategy introduced at the beginning of 2014, although we go several steps further in this direction. In Section 3.4 on ownership and governance, we address the question of how to incorporate the broader social and economic objectives necessary to tackle the market failures set out in Sections 2.2 and 2.3. We then deal with a number of practical considerations to implementing such a reform in Section 3.5.

3.1 The public service mandate

The new RBS would be a UK retail bank focused on households and local businesses, including social enterprises and charities. Allowing for a transitional phase of restructuring, each local bank within the banking group should be a separate legal entity with its own articles of association.

The public service mandate is enshrined within the German savings bank sector by federal and state laws that set out the requirements for using the 'Sparkasse' name. This may include objectives such as promoting savings and financial inclusion, laying out what can be done with profits, for example kept aside as a capital cushion or donated to local charitable/scientific projects, and a focus on supporting SMEs. The activities that savings banks cannot engage in, such as proprietary trading in financial markets, are also laid out in

state savings banks laws. In addition, each bank incorporates its social mission explicitly in its own articles of association.

We suggest that the articles of association of the RBS Group and its constituent local banks should set out the objectives of the bank as set out in Box 2:

Box 2: Objectives of new RBS local banks

The objective of the bank is to serve the common good by the provision of financial services according to the following principles:

1. to restrict its activities to the geographic region in which the enterprise is domiciled;
2. to conduct the bank's business so as to benefit the economy of the region;
3. to promote positive attitudes to saving and to advance financial literacy;
4. to provide access to basic transactional banking services to all citizens regardless of income, wealth, or social status;
5. to provide access to personal credit on fair and affordable terms;
6. to support private, social, and public enterprise through the provision of appropriate financial products and services, including advice;
7. to manage the bank's capital prudently; and
8. to earn sufficient profits to grow the bank's capital, to maintain its commercial vitality, and to invest in the delivery of its objectives.

The bank's directors shall be empowered to exercise their judgement to balance these objectives according to the conditions and circumstances of the region they serve, with the application of due diligence and appropriate expertise.

The bank shall aim to generate profits, but generating profits is not the primary purpose of the bank.

In order to ensure this mission is not altered in the future, we recommend that there should be safeguards embedded both in banking regulation and legislation, and in the organisation structure of the bank. We examine these aspects in Section 3.4.

3.2 Focus on UK retail banking

In April 2014, RBS announced a new strategy to focus on UK retail banking and simplified its structure, grouping its activities into three distinct businesses.⁸⁶ The separation of personal and SME deposits from riskier parts of the business is in line with the 2013 Banking Reform Act, which requires banks to ring-fence their retail activity from investment banking.⁸⁷

- **Personal & Business Banking (PBB)** serves UK personal and affluent customers (UK PBB), including in Northern Ireland through Ulster Bank, together with small businesses (generally reporting up to £2 million turnover).
- **Commercial & Private Banking (CPB)** serves commercial and mid-corporate customers (Commercial Banking) and high-net-worth individuals (Private Banking), providing trade and foreign exchange services to commercial clients operating overseas.

- **Corporate & Institutional Banking (CIB)** serves corporate and institutional clients primarily in the UK and Western Europe, as well as those US and Asian multinationals with substantial trade and investment links in the region, with debt financing, risk management, and trade services.

In addition to these core continuing activities, the bank is selling its US bank, Citizens Financial Group, and has transferred high risk assets into the so-called bad bank – RBS Capital Resolution.

In order to comply with conditions attached to the state bail-out of RBS in 2008, it has commenced the sale of Williams & Glynn, a new bank with 314 branches, approximately £20 billion of loans and £22 billion of customer deposits.

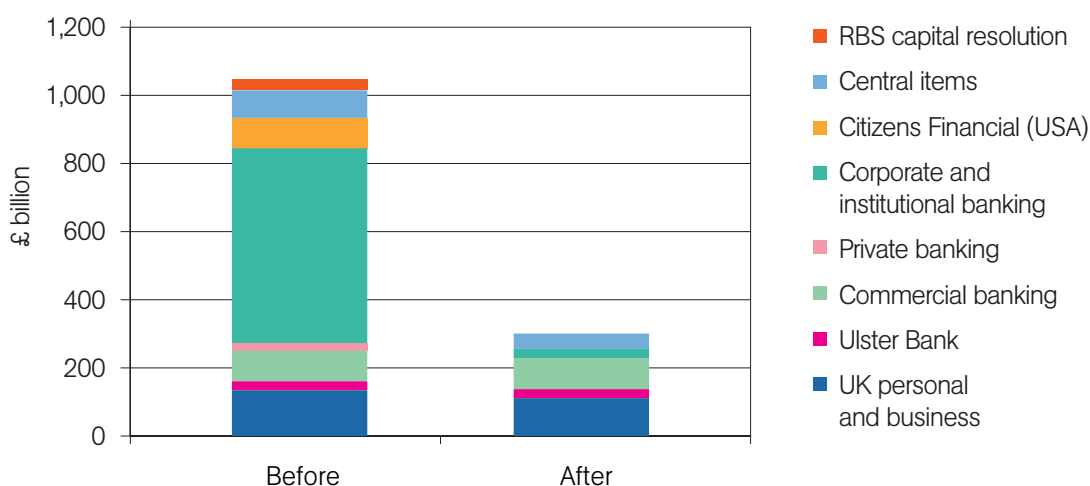
We consider this strategy to be in the same direction of travel as our proposal to create a local stakeholder banking network, but we would go further in focusing on the UK high street.

To align with its new public interest mandate, the bank should divest the Corporate & Institutional Banking business. These are activities that are best suited to be returned entirely to the private sector. Only those financial market activities essential to providing services to commercial clients, for example in foreign exchange, or integral to sound liquidity management for the group should be retained.

The Private Banking business for high-net-worth individuals should also be sold on the basis that there is no case for market failures in the provision of financial services to the wealthy that would merit a public interest mandate bank in this market.

The Commercial Banking and Personal & Business Banking divisions, in other words the high street bank, would be re-organised as a network of autonomous local banks, each with a distinct local focus as described in the following section. The impact on the balance sheet of RBS is illustrated in Figure 9.

Figure 9. RBS assets in each business unit before and after restructuring



Source: NEF calculations set out in Appendix A1 from RBS results for Q3-2014

RBS is currently simplifying its administrative activities in line with this restructuring. As it stands there is an internal department that manages the Group's capital position (i.e., treasury functions); takes responsibility for financial reporting; ensures that the bank complies with regulations; assists with risk management; provides human resources, legal and communications support; and is responsible for information and communications technology, fraud prevention, payment processing, 'back' and 'middle office' services, such as trade matching, and other operational matters.

These functions are being significantly scaled down, cutting the number of technology platforms used across RBS in half and reducing the number of payment systems from 80 to 10.⁸⁸ These simplified systems would play an important role in the re-localised RBS, providing central services that allow the network of local banks to retain economies of scale.

Impact on RBS's capital position

In June 2013, the Prudential Regulation Authority (PRA) published the results of its capital shortfall tests on British banks.⁸⁹ This analysis concluded that RBS had a £13.6 billion capital shortfall to close before the end of 2013, of which £10.4 billion would be provided by existing plans to sell its US retail bank, Citizens Financial, and further prune its investment banking department.⁹⁰ The latest Bank of England stress tests suggested that although RBS needed to strengthen its capital position further, it was on course to achieve the desired capital position without further management action.⁹¹

The impact on the financial position of RBS of selling its investment banking (CIB) and Private Banking divisions would be to release a significant amount of surplus capital that could be used to bolster the bank's capital position or to make a significant return of capital to shareholders, or both. Using estimates of each division's tangible equity set out in Table 2 we estimate that capital of around £1.5 billion from Private Banking and up to £14 billion from CIB could be redeployed to other divisions or returned to shareholders, although the eventual proceeds of CIB is hard to estimate due to its low profitability and uncertainty over the final settlement of various regulatory actions and litigation against the bank (discussed in more detail in Section 5.1).

Table 2. Divisional risk weighted assets and equity

Division	Risk Weighted Assets	Nominal Capital
		12% of RWA
Personal & Business Banking	44.7	5.4
Ulster Bank	23.9	2.9
Commercial Banking	64.9	7.8
Private Banking	12.2	1.5
Corporate & Institutional Banking	123.2	14.8
Central	17.8	2.1
Citizens Financial Group	64.4	7.7
RBS Capital Resolution (Bad Bank)	30.6	3.7
	381.7	45.8

3.3 Local scale

At what scale should the new local banks be organised? Local banks in different countries, and within any given country, tend to vary in size.

- German savings banks mostly have assets in the range £0.5 billion to £4 billion with £1.0 – £1.5 billion being the most common. A small number are over £10 billion.
- Swiss cantonal banks range widely between £2 billion and £19 billion, with a small number over £27 billion.
- Norwegian savings banks in contrast are mostly under £1 billion in assets with £200–£300 million commonplace.

The German Savings Banks Association (DSGV) advised that the areas covered by a local bank should be determined by which neighbouring locations have an affinity with one another and have similar economic characteristics. It emphasised that, as long as a network model is deployed, one should not be overly concerned with a bank being too small, as the wider network will mean that it is still economically viable. However, it did caution about local banks becoming too large, and said that it had received complaints that the two largest Sparkassen, Hamburger Sparkasse and Sparkasse KölnBonn, with £32.5 billion and £23.6 billion in assets, respectively, were becoming out-of-touch with customers.

We propose that the degree of decentralisation of the bank within Scotland, Wales, and Northern Ireland (Ulster Bank) should be considered a matter for the devolved administrations, and for this analysis we will focus on what an appropriate level of scale for local banks would be in England.

One potential basis for determining geographic areas is Local Enterprise Partnerships (LEPs). These local bodies were introduced in 2011 to replace the previous nine Regional Development Agencies. They comprise local politicians, public sector workers, and business and industry representatives. England was broken down into 39 LEPs, and the bodies were given the task of advising local authorities on how they should invest and take action to boost local economic growth and job creation.

Some LEPs match with existing unitary authority boundaries, such as Cornwall or the Isle of Wight. Others operate at a more regional scale, for example the Heart of the South West, which includes quite diverse local economies from the naval industrial city of Plymouth to rural Somerset.

While having sub-regional banks operating at roughly the same scale as LEPs would be a vast improvement in the diversity of UK banking operations, it would not provide anywhere near the same degree of localism as the German Sparkassen. There are 417 Sparkassen in Germany,⁹² which is equivalent to one bank per 193,000 people.⁹³ In contrast, the 39 LEPs in England correspond to one LEP per 1.37 million people.⁹⁴ Given the DSGV's warning about the dangers of the largest Sparkassen becoming too remote from their local market and community, this may mean that LEP boundaries may be too large for truly local banks.

An alternative would be to base the local banks on local authority boundaries at the level of London boroughs, unitary authorities, metropolitan counties, and shire counties. These are listed in Appendix 2. Basing the banks on local authority areas would produce between 100 and 150 local banks in England comprising:

- 27 shire counties
- 54 unitary authorities
- 36 metropolitan boroughs (which could be organised into 6 metropolitan counties of Greater Manchester, Merseyside, South Yorkshire, Tyne and Wear, West Midlands, and West Yorkshire)
- 33 London boroughs, including City of London (which could be combined into, say, 12 groups)

The close proximity of London boroughs suggests that branches in these areas should be grouped together into between 8 and 16 groups of inner and outer London boroughs, subject to consultation. Assuming 12 new London banks, and assuming that the 36 metropolitan areas have separate banks rather than combining into the larger metropolitan counties, the total number of English local banks would be 130. This equates to an average of one bank per 408,000 people, varying in size between 1.47 million in the County of Kent to 37,600 for the Rutland Unitary Authority area. Subject to consultation, merging areas with a population under, say, 150,000 with adjacent banks might be permitted but it should be remembered that the economies of scale are provided by membership of the network and not by each individual bank having to attain a sufficient scale to be a stand-alone bank.

Deposits and loans can be allocated to appropriate local banks on a basis of the customer's address. Other central costs and infrastructure, such as IT systems, treasury functions, legal and compliance services, interbank assets and liabilities, and bonds, are provided centrally within the RBS Group and would continue to be provided centrally within the new network of local banks.

To illustrate the financial scale of the local bank network, we produced a proforma allocation of assets to each local bank within England based on the population of the area it serves. For Northern Ireland, the assets are taken to be as disclosed for Ulster Bank, and the allocation for Scotland is based on estimates of RBS market share in Scotland.

Within England, this would result in 130 local banks, of which half would have total assets of between £1 and £2 billion. Only seven would have assets greater than £4 billion, with the Bank of Kent being the largest at £6 billion. Only four would have assets lower than £500 million. The scale of these banks would be commensurate with the German savings banks and would tap into existing local identities. Table 3 shows the how these local banks would be spread around the English regions, with some examples to illustrate their geographical focus.

Table 3. Location and size of new local RBS banks

Region	Number of banks in region	Total banking assets in region	Examples
		£bn	£bn
North East	12	10.6	County Durham Bank: 2.1 Bank of Middlesbrough: 0.6
Yorkshire and Humber	15	21.7	Bank of Sheffield: 2.3 Bank of Barnsley: 0.9
North West	23	28.9	Bank of Liverpool: 1.9 Rochdale Bank: 0.9
West Midlands	14	23.0	Bank of Birmingham: 4.4 Herefordshire County Bank: 0.8
East Midlands	9	18.6	Bank of Nottingham: 1.2 Lincolnshire Bank: 2.9
East of England	11	24.0	Bank of Norfolk: 3.5 Bank of Southend: 0.7
London	12	30.5	Bank of Lewisham and Southwark: 2.3 Bank of Enfield and Waltham Forest: 3.4
South East	19	35.4	Oxfordshire County Bank: 2.7 Bank of Portsmouth: 0.8
South West	15	21.7	Bournemouth Bank: 0.8 Arghantti Kernow (Bank of Cornwall): 2.2
Total in England	130	214.4	

Source: NEF calculations. Assets are allocated in proportion to population of area.

One disadvantage of having areas of operations closely aligned with political boundaries is that these do not necessarily reflect economic areas and it would be important to ensure that the bank was not too closely identified with political authorities. Defining local economic areas is an intractable problem, as the experience of LEPs shows – economic areas overlap and operate at many different scales. In practice, a sense of local identity and place for a stakeholder bank is more important than attempting to define a distinct economic zone within national boundaries. On the question of the danger of political interference, this is a matter of designing good governance structures, which we discuss in Section 3.4.

The final choice of boundaries should be subject to local consultation within guidelines for scale and proximity to ensure that geographical boundaries are connected closely enough with the local household and business markets that it is the bank's mission to serve.

3.4 Ownership and governance

In this section we consider which ownership and governance structures would best suit the new public interest mandate of RBS.

Ownership forms can be seen as a spectrum from narrowly focused private benefit in the case of shareholder ownership to highly diffused public benefit in the case of state ownership (Figure 10). Co-operatives have a broader private benefit, usually being owned by their customers, and the trust model can have other beneficiaries depending on the trust's mandate. We do not consider that direct state ownership or management is a desirable option for public banks, for reasons discussed in Section 2.4. Therefore we consider in more detail the other three options for RBS: private shareholder ownership, co-operative/mutual ownership, and public benefit trust ownership.

Figure 10. Spectrum of corporate ownership forms

Shareholder	Co-operative	Trust	State
<ul style="list-style-type: none"> • Primacy of profit / return on equity • Control proportionate to investment • Shares in capital are owned by shareholders • e.g. Barclays, HSBC, Tesco, Co-op Bank 	<ul style="list-style-type: none"> • Primacy of value for members • Control equal per member • Shares in capital are owned by members • e.g. Rabobank, Co-operative Group 	<ul style="list-style-type: none"> • Primacy of value for beneficiaries • Control by boards, elected or appointed • Capital 'unowned' and cannot be distributed • e.g. Sparkassen, John Lewis 	<ul style="list-style-type: none"> • Primacy of state objectives • Control by government /civil servants • Capital is owned by the state • e.g. Green Investment Bank, NHS

In assessing the most suitable structure for the new RBS, the key criteria are to ensure that the bank

- remains locally managed.
- is run on commercial lines without political interference.
- has strong local stakeholder relationships.
- fulfils both its financial and social missions.

The other factors to be taken into consideration in choosing the form of ownership are operational efficiency, efficient allocation of credit, and access to capital. We discuss these where they are relevant, but the fundamental point about the new public interest mandate of RBS is to deliver the broader social and economic benefits of local stakeholder banks set out Section 2, not to maximise returns on capital.

Private shareholder ownership

The case of US community banks suggests that private ownership, particularly family owned banks or banks whose shares are held locally by long-term investors, can support a local mission. However, the large number of community banks is a result of historic regulation that has changed. In the past, a US deposit-taking bank had to obtain a charter from each state in which it operated.⁹⁵ Banks also had to set up a separate legal entity in each state, which prevented them using one brand in multiple states. In the 1980s, states started to become more flexible with their requirements, and came to agreements with neighbouring states to allow banks to operate across state lines. Finally, in 1995, nearly all restrictions on interstate banking were lifted by Clinton's Reigle-Neal Interstate Banking and Branching Efficiency Act.

Since then, nationwide banks have been on the rise, while the number of community banks has steadily fallen. For example, in 1985 there were nearly 18,000 community banks;⁹⁶ now there are now only 7,000.⁹⁷ There are no significant barriers either in regulation or the banks' own legal constitutions to this trend continuing until, as in the UK, the local banking sector has greatly diminished through mergers and acquisitions.

Handelsbanken is a large Swedish multinational bank that shares some of the characteristics of local stakeholder banking networks because, since the 1970s, it has devolved power to its local branches. As we saw in Section 2.3, Handelsbanken demonstrates many of the characteristics of local banks such as devoting a larger percentage of its balance sheet to lending to businesses and individuals, and typically generating more stable returns. However, there is no constitutional or regulatory barrier to a future management board or owners deciding to change strategy and return to a centralised model.

Therefore we consider private ownership to be very weak on the criterion of staying local. Although some private bank owners may choose to trade off profit for increased social impact, there is no inherent embedding of a social mission and so we consider them to be very weak on this criterion, too. Relationships with local stakeholders will depend on the approach and attitude of owners and so we rate this as neutral. Where local private shareholder ownership is strong is in offering a high degree of protection from political interference.

Co-operative ownership

Cooperative banks account for a significant proportion of the banking market in many countries, particularly in Europe. They are owned and controlled by their members (usually their customers) on the basis of one vote per person, rather than by shareholders, whose vote is proportional to their financial stake.

Members invest a small amount of money in the cooperative to buy a share, which cannot then be traded among members or third parties. Instead, you can only sell them back to the bank itself in order to reclaim the money you originally put in. Furthermore, unlike shareholders in joint stock companies, cooperative members do not have any legal claim on the profits generated by the businesses, or any share in the appreciation in the value of the business. Cumulative profits are instead owned by the cooperative itself.

Mutuals, such as building societies in the UK, are similar to cooperatives, although they differ in important respects. Customers of mutuals automatically become members rather than choosing to and, unlike members of cooperatives, cannot usually run for election to the supervisory board.

The ownership structure of cooperative banks appears to have a profound effect on the priorities and performance of these institutions.⁹⁸ Customer ownership places incentives on managers to maximise long-term customer value. The resulting focus on high-street banking, inclusive approach to customers, and prudent approach to risks and managing capital have positive benefits for the economy as a whole as well as for individual customers. As a result we rate this structure as strong for social mission, stakeholder engagement, and protection from political interference.

There are few constitutional impediments for members of co-operatives to choose to merge with other co-operatives, if they judge this to be in their personal interests as customers. This is illustrated by the decline in the numbers of UK building societies from 1,723 to 49 over the past century. Just one of these – the Nationwide Building Society – accounts over half of the sector's assets and operates as its name suggests on a nationwide basis rather than having any local geographical focus.

Therefore we rate co-operative and mutual structures, in the absence of new regulatory or legal constraints⁹⁹ on mergers or demutualisation, as weak on protection for staying local.

Public trust banks

When a bank is run as a public trust for the benefit of the local economy and citizens, its capital is in essence unowned, making it inherently hard to sell. However, privatisation is not impossible. For example, the UK used to have a thriving trustee savings banks sector, which has now been completely lost (Appendix A3).

As a result, many countries take extra steps to protect public banks. For example, in Germany there is no legal way to privatise a public law institution. To do this, one would have to lobby for the local state savings bank act to be changed, and then persuade the local municipalities to agree to their savings bank being sold off. Given that there are 1,557 municipalities and 16 states in Germany, a very significant amount of lobbying would be required to get rid of the German savings banks sector.

Norwegian savings banks are also protected against privatisation by legislation. Privatisation is possible, but requires approval by the financial regulator. The latter can also limit the extent of privatisation; for example, by specifying that 25% of the bank's capital must remain unowned, and the majority of the voting rights must lie with the supervisory board – elected from depositors, employees, and, for some banks, local authorities.

It is also easier to impose geographical restrictions on an unowned bank than on an owned one. For example, German state savings banks laws subject Sparkassen to a 'regional principle', where the precise geographical region the bank can operate in is specified and non-negotiable. Similarly, the Swiss

cantons define the general principles by which their cantonal bank should operate, including its geographical boundaries.

Political interference

Public trust banks such as the German savings banks, Sparkassen, have a social mandate, such as supporting the local economy, but are not controlled by the local or national government, and so cannot be used as vehicles to enact public policy. As we discussed in Section 2.4, the case of the local Spanish savings banks, Cajas, was very different, however, with local political interference in investment decisions being a factor in the failure of this sector. Here we draw lessons from the much more successful German model.

In 1931, the Sparkassen were given legal independence from their local authorities, and are now ‘public law institutions’. This is a legal category that does not exist in UK law; however, it is similar to trust ownership, in that no one owns the assets, i.e., the bank owns itself, and the institutions have trustees (usually the local municipalities). The ownership structure was chosen to protect the banks from investors buying them and diverting them from their social mandates.

While municipalities are typically trustees, they have no power to sell the bank or distribute profits. Furthermore, municipalities are not the only trustees, with other local stakeholders sitting on the supervisory boards. This board is charged with ensuring the bank fulfils its public mandate, as laid out in the applicable state savings bank act.

Conclusion – implementing the public trust model

Different organisational structures perform differently when considered against four criteria of remaining local, resisting political interference, stakeholder engagement, and social mission, as summarised in Table 4. Both co-operative and public trust structure perform well across all the criteria¹⁰⁰ with private local banks and state run banks having strengths but also severe weaknesses.

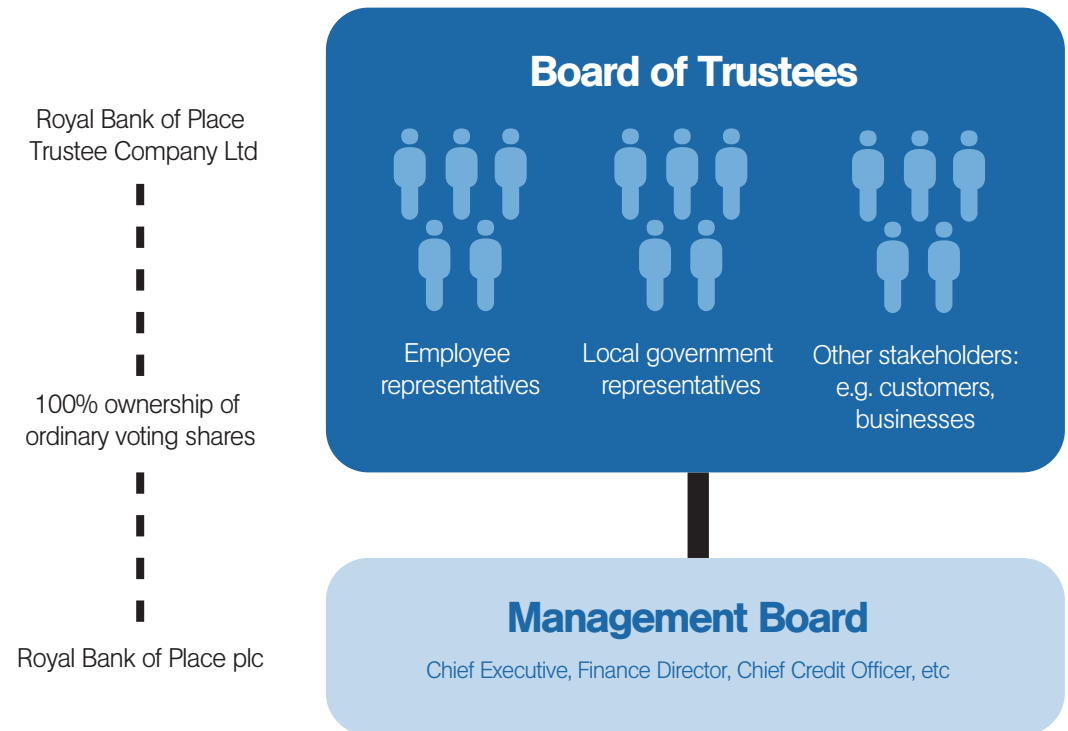
Table 4. Matching organisational structure with mission

Criteria	Stock market	Local shareholder	Co-operative	Public Trust	State control
Stays local	—	•	••	•••••	••
No political interference	•••••	•••••	•••••	•••••	•
Stakeholder engagement	•	•••	•••••	•••••	•••
Fulfils social mission	—	••	•••••	•••••	•••••

Key: — Not relevant • Very weak •• Weak ••• Neutral •••• Strong ••••• Very strong

We conclude that the most appropriate ownership and governance model for a restructured RBS would be the public trust. This is similar to the ownership and governance model of retail group the John Lewis Partnership. The John Lewis Partnership Trust holds all the shares in the operating retail company in trust for the benefit of the employees. A similar two-tier structure for the local RBS banks is set out in Figure 11.

Figure 11. Ownership and governance structure of local RBS banks



While the Management Board, which has responsibility for the day-to-day running of the bank, should be composed of financial services professionals, the Board of Trustees, which sets the overall strategy for the bank and holds the Management Board to account for delivering against the bank's objectives, should be composed of stakeholder representatives.

We suggest three groups of stakeholders should be represented:

1. **Local government** – to provide broad representation of the citizens of the local area, one-third of the trustees should be nominated by elected representatives. It is not the ruling party that controls the nominations and instead the right to nominate representatives would be given to all political groups, including those sitting as independents, in proportion to the votes cast at the most recent local election. This formulation prevents domination by a single party. The restriction of political representation to one-third of the Board of Trustees prevents the likelihood of interference in the banks decisions about individual lending projects, over which the Board of Trustees in any case has no jurisdiction.
2. **Employees** – one-third of the Trustees are elected by the bank's employees. Worker representation on the supervisory board not only ensures that a vital stakeholder voice is heard, it can also serve as a source of on-the-ground intelligence for the Board as a whole, shortening the long lines of communication that exist in command and control hierarchies.¹⁰¹

3. Other local stakeholders – to provide both insight and oversight for the delivery of the bank's public interest mandate requires representatives from other key stakeholders, such as personal customers, both depositors and borrowers, local chambers of commerce, and representatives of other civil society organisations, such as social enterprises and charities and educational institutions.

Stakeholder governance theory and practice support the provision of checks and balances on the exercise of executive power and hence guard against corporate governance failure.¹⁰² The Trustees should be competent to exercise effective supervision over executives and, unlike Trustees of charities, Bank Trustees should be paid for their time and offered appropriate financial and management training, as is the case for members of the supervisory boards of German savings banks.¹⁰³

This public trust model might seem novel for a UK bank but it is not only based on the success of John Lewis Partnership in operating this model for over 80 years, and based on the best practice of governance of local public interest banks in other countries, it is a return to the roots of British banking in the Trustee Savings Bank (TSB) movement (Appendix A3). The current TSB as a shareholder-owned national bank bears no resemblance to this movement other than ownership rights over the brand. However, there is one TSB remaining in its original form: the Airdrie Savings Bank operates eight branches in the area east of Glasgow. With total assets of £158 million, it is around one-tenth of the average size of the proposed new local RBS banks and has operated independently and successfully for 180 years.

Restructuring RBS into a network of local trustee banks offers a chance to revive a valuable part of Britain's banking history in order to secure a more prosperous future.

3.5 Dealing with practicalities

There are a number of practicalities to be dealt with in order to transform RBS into a network of local public trust banks. Our research indicates that all can be overcome, although as we set out in Section 5, these will require further detailed research and consultation. The most significant barrier is presented by the minority interests in RBS – the shares still traded on the London stock exchange and the institutions that own them.

Minority shareholders

The government currently owns 81% of RBS – a stake that was arrived at through the process described in Box 3. There are three different types of share as set out in Table 5.

Table 5. RBS market capitalisation

Class of share	Shares	Gov't stake	Price	Mkt cap	Gov't stake	Minority interest
	million	(%)	pence	£bn	£bn	£bn
Ordinary A shares	6,321.5	63%	380.0	24.0	15.1	9.0
Non-voting B shares	5,100.0	100%	—	19.4	19.4	—
Dividend access shares	0.00	100%	—	—	—	—
Total	11,421.5			43.4	34.4	9.0

The dividend access share (DAS) is a special share owned by the government that was issued as part of the bail-out terms. In short, it ensures that no dividends can be paid on ordinary shares without paying out significantly over and above this to the government. In April 2014, an agreement was reached for RBS to buy-out the DAS at an overall cost of £1.5 billion.¹⁰⁴ The first payment of £320 million was made in 2014 and RBS is incentivised to pay the remaining £1.18 billion in 2015, after which a 5% annual surcharge will be applied.

Box 3: The bail-out of RBS

In October 2007, RBS acquired the Dutch bank, ABN AMRO, after a contested takeover bid. When the financial crisis struck in 2008, it became clear that the acquisition had overstretched RBS's already highly leveraged balance sheet. The combination of the takeover with £6 billion losses on mortgage-backed derivatives left the bank dangerously short on capital.

Having failed to raise sufficient funds in the market, in October 2008 the UK government purchased 22.9 billion of newly issued preference shares in RBS for 65.5p per share (£ 15.0 billion in total) to recapitalise the bank. In April 2009, the government agreed to convert its preference shares into ordinary shares to prevent the payment of annual dividends on the preference shares being a further drain on the bank's capital.

A further 16.8 billion shares were purchased for £5 billion, increasing the government's total holding to 39.6 billion shares (66% of the ordinary share capital).

In addition, in late 2009, in exchange for access to the Asset Protection Scheme and an injection of £25.5 billion, RBS issued the government 51 billion B shares and a DAS. The non-voting B shares were required in order to maintain a stockmarket listing for the ordinary voting shares. Stockmarket rules require that the free float (non-government stake) be at least 25% of the voting share capital. The B shares have the same dividend rights as ordinary shares, but no voting rights. However, they are assumed to have the same value as ordinary shares.¹⁰⁵

The average price paid for all the government's stake was 502p per share,¹⁰⁶ which means it spent £45.5 billion. Net of payments to the government since then, UK Financial Investments (UKFI) states the net cost of the taxpayer bail-out to be equivalent to 482p per share. This excludes the additional interest cost to the government of funding the bail-out and also the fees paid by the bank in respect of other government support schemes.

A key question for placing the government's stake into a public trust is what should happen to the remaining minority ordinary shareholders. The first option would be to leave them as they are. This would place an expectation on RBS of resuming dividend payments to ordinary shareholders in the future, which is likely to dilute the advantages of stakeholder banks of not needing to focus on maximising short-term profits and their ability to retain profits to build up capital reserves rather than pay them out as dividends.

The more important issue would be whether any such arrangements would be considered fair treatment to minority shareholders who might end up with an investment in an entirely new and unknown banking structure without having a choice in the matter.

The alternative option would be for the government to buy out the minority shareholders to achieve 100% ownership of both classes of share. It would need to launch a takeover bid for the remaining shares under the City Code for Takeovers and Mergers. It is usual to offer a premium of 20–30% to the price at which shares are trading pre-bid, although this is largely to represent the economic value of gaining control, defined as more than 50% of the voting shares. As the government already has a controlling interest, it arguably need not offer a large premium. Once a shareholding of 90% has been acquired, the remaining shareholders can be forced to sell to enable full ownership to be achieved.¹⁰⁷ The current value of the minority shareholding is £8.5 billion and at a premium of 15% the cost of a full buy-out would be approximately £10 billion.¹⁰⁸

We believe that it should be possible to recover this sum from the proceeds of divesting the Corporate & Institutional and Commercial & Private Banking divisions so that the purchase of the remaining shares would be cash neutral for the public finances. We discuss the implications of this for the economic impact of retaining RBS in public ownership in Section 5.2.

The reality of capital market dynamics means that the share price will react to any announced or even anticipated changes in government policy towards its stake in RBS. The approach to minority shareholders is a subject that would require further consultation, including legal opinion.

National accounts and government debt

Currently RBS is listed as a *public financial corporation*, and is considered to be part of the *public sector*. For accounting purposes, the public sector includes both *general government* and *public corporations*, such as BBC World Service, Channel 4, and Historic Royal Palaces.¹⁰⁹ General government refers to anything that is controlled at the national government level, for example, the NHS, the Home Office, and quangos, whose liabilities one would expect to be included in government debt. However, the UK is rather unusual in also including public corporations in contrast to most countries where only general government institutions' debt is included.¹¹⁰ The different elements are shown in Figure 12.

Figure 12. Accounting for public debt



The RBS balance sheet after restructuring will only count as part of the national public debt if it is classified as a public corporation. The National Accounts Classification Committee (NACC), part of the Office for National Statistics (ONS), is responsible for determining which institutions are private and which are public corporations; it does this on a basis of who *controls* the institution, not who owns the institution. The criteria for assessing control are set out in Table 6. In some cases, the presence of only one indicator is enough to be judged public sector control, but in others it is the balance of a number of indicators.

Table 6. Criteria for deciding if the government has a controlling interest

<i>Does the government have the ability to:</i>	
Constitutional control	<ul style="list-style-type: none"> • change the constitution of the body, or veto changes to it; • prevent the body from ending its relationship with the public sector; or • close the body?
Strategic control	<ul style="list-style-type: none"> • have a final say in sale/acquisition of fixed assets; • be entitled to a share of proceeds of asset disposals that goes beyond the repayment of previous government support for capital formation; • veto any takeover (except in the case of a conventional special share); or • approve acquisitions (other than as industry regulator)?
Operational control	<ul style="list-style-type: none"> • determine aspects of how the body delivers its outputs; • decide what sort of financial transactions the body can undertake, or limit them; • prevent the body from receiving certain types of income from other sources; • exert numerous minor controls over how the body is run; • exert financial control (n.b. this is different from funding) as part of a general system of controlling public expenditure; • control dividend policy; or • set pay rates?

Following the bail-out, the government was deemed to have a controlling share in RBS, and thus RBS became a public sector corporation, so all the bank's debts plus the cost to the government of buying shares in the bank now counted towards (and greatly increased) the Public Sector debt.

In light of this sudden extraordinary increase in Public Sector debt, the usual indicator used, called Public Sector Net Debt (PSND), was amended to PSND ex, which excluded RBS's liabilities and the cost of buying shares, as both were deemed to be 'temporary' measures. This prevented the official measure of public debt from rising dramatically. The exclusion from the UK's own rules was justified by the logic that the bank bail-out measures were only temporary, and so should not be viewed in the same way as the government's long term debts. PSND ex thus became the measure that the government and commentators refer to when discussing fiscal policy targets.

As the liabilities of public banks do not affect national debt figures under common international practice, this is entirely a self-made problem for the UK, which also is a constraint on the BBB and the Green Investment Bank. In practice, by adopting PSND ex, the ONS has found a way around its own rules in respect of government stakes in RBS and Lloyds. We suggest that the UK should instead simply fall in line with international common practice for public accounting.

Any increase in government shareholding up to 100% as part of the restructuring process should not change the existing classification, as it would be only a temporary arrangement and therefore not included in PSND ex. The real question is whether the government would retain control over the bank once transferred to trust ownership.

This is fundamentally a question of design for the new ownership and governance structures. As the intention that the new local banking network should be permanently independent of government control, the governance should be designed to meet the NACC's criteria for independence. The liabilities of the new RBS should not therefore be counted as part of the public sector any more that the original TSBs were prior to their privatisation.

EU state aid rules

We consulted staff at the European Commission (EC) to gain further clarification on whether buying out minority shareholders and retaining the bank in public ownership would violate EU state aid rules. There are various conditions that must be fulfilled for a market intervention to count as state aid. For example, the action must deploy public funds, and it must potentially distort the market. It is this second criterion that is of particular relevance to our proposal. EC staff advised that if RBS shares were purchased in the secondary market at secondary market prices, then the state would not be behaving in a manner inconsistent with any other market actor. Furthermore, the transaction would entail public money being transferred to the investors that currently hold the shares – a markedly different situation to the RBS bail-out, where public money was injected into the bank itself to shore up its capital position, which gave RBS an unfair advantage over other banks.

Their informal indication was therefore that purchasing shares on the stock market would not likely be viewed as distorting the market, and so would not qualify as state aid, or be subject to EU state aid rules.¹¹²

Would the structure and mandate of the new RBS constitute unfair competition? The EU state aid rules aim to ensure fair competition and a single common market. Giving favoured treatment to some businesses would harm their business competitors and risk distorting the normal competitive market; hinder the long-term competitiveness of the community by propping up inefficient, aid-dependent companies; and allow those member states with the deepest pockets to favour their own industries.

Support has to pass four tests for it to count as state aid:¹¹³

1. It has to be granted by the state or through state resources.
2. It has to confer a selective advantage to an undertaking – i.e., some undertakings get it and some do not.
3. It has to distort or have the potential to distort competition – i.e., strengthen the beneficiary relative to competitors.
4. It has to affect trade between member states – in practice affect any market where the goods or services are tradable between member states.

In the run-up to the financial crisis, many local public banks in the EU found themselves the subject of complaints by commercial banks to the EC. Commercial banks argued that explicit local government and state backing was giving public banks an unfair competitive advantage. For example, commercial banks complained to the EC about *Anstaltslast* (state guarantee for Landesbanken) and *Gewahrtragerhaftung* (municipality guarantees for savings banks). The EC said that Sparkassen could keep their guarantee on their public interest operations, but only if these operations were separated from the rest of the bank. After much deliberation, the DSGV rejected this proposition, as the Sparkassen viewed their public interest functions as being inseparable from their other operations. As a result, German Sparkassen and Landesbanken had their state guarantees removed in 2005. Similarly, guarantees for Austrian saving banks were removed at the request of the EC in 2003.¹¹⁴ Local banks then took measures to try to compensate for the absence of state backing. For example, Sparkassen increased the guarantee amount under their joint-liability scheme, and also increased monitoring and central decision-making in the instance of a savings bank failing.

All this strongly indicates that as long as a reformed RBS is not explicitly guaranteed by local or national government, then the local banks should not fall foul of EU state aid rules.

Regulation

Although each of the 130 new local banks would have its own banking licence, this does not mean that they should be individually regulated by the Prudential Regulatory Authority and Financial Conduct Authority as if they were separate stand-alone banks. We suggest this would not reflect the reality of their membership of the wider RBS network.

Following best practice in other local stakeholder banking networks, a system of mutual guarantees would both improve the internal auditing and management of risk within the network, and provide the same diversification of risk that national banks achieve. A national bank does not need to be overly concerned with a downturn that affects just one industry or region, say, due to a decline in car manufacturing, because this is only one of the many different areas and industries that it operates in. However, a local bank that only operates within the depressed area may soon find itself in trouble. A local bank network guarantee fund helps overcome this problem by diversifying risk across the entire country and different sectors of the economy.

For example, the German savings banks network operates three guarantee schemes, one for the savings banks, one for the Landesbanken, and one for regional building societies. These three funds together form a Joint Liability Scheme. Let us briefly look at one of these funds – the scheme for savings banks – in a bit more detail (the three schemes are all very similar).

The Savings Banks Guarantee Fund monitors risk amongst its members, and can exercise intervention rights as soon as problems are detected in a member bank. The fund also has the right to audit its member banks at least once a year. The fund demands annual levies that are proportional to the risk profile of each individual bank. It also produces an annual report every year that is submitted to the German Federal Financial Supervisory Authority and the DSGV.

When a savings bank gets into trouble, it can apply to the guarantee fund's Board for access to the fund. The Board will then decide, with a two-thirds majority, if various criteria have been fulfilled, for example liquidity and solvency ratios falling below given thresholds, and what type of support is most appropriate. There are various limits in place to protect against any one bank overusing the fund. For example, no more than 2% of a bank's balance sheet can be injected into the bank as equity, and no more than 10% of the guarantee fund in total can be used to buy equity in troubled banks.¹¹⁵ If the fund ever thinks it is necessary to breach any of these limits, it must first get permission from the savings banks network's presidium. When providing support to a bank, the guarantee fund will also usually impose reciprocal restructuring demands on the institution, such as selling assets, cutting staff, and mergers.

These systems of mutual guarantees with auditing and intervention rights act as a very effective discipline on bank managers to manage risk prudently. A relocalised RBS should follow examples set overseas and set up and administer a guarantee fund for its network. Therefore we suggest that the RBS network could be regulated under a single banking network licence introduced for the purpose.

Brand identities

For most customers outside Scotland, when they transact with RBS they will experience this as a transaction with NatWest, the predominant brand in England and Wales. The sale of Williams and Glynn branches in England, which are RBS branded, will complete the division of the brands into RBS in Scotland, Ulster Bank in Northern Ireland, and NatWest in England and Wales.

Which should be the brand of the new local banks in England and Wales? This should be a matter for market research among customers and the public but whichever is chosen should combine national recognition for the overall group identity with distinct local identity.

The Sparkassen network achieves this through individual bank names, based on the location, which all include the term Sparkasse and the savings bank logo.

One option is to retain the brand styling of NatWest while adoption the name formulation of 'Royal Bank of'. We shall adopt this formulation in our case study examples later in this section.

Building local expertise

Centralised credit-scoring and decision-making has been in place at all the major banks for a significant period of time and it has been suggested that current bank staff now lack the in-depth local knowledge and credit assessment expertise necessary to devolve lending decisions to local level. However, this is exactly the problem that Handelsbanken faced when entering the UK market in 1980, since when it has shown strong growth in its branch network and loan book.

When interviewed, a representative from Handelsbanken argued that British bank employees have all the necessary skills, they are just not usually given the freedom to exercise their judgement. They also emphasised that one should not expect immediate results, but instead have confidence that staff will build up the required local expertise when the bank structure gives them incentives to do so.

In a BBC interview, a Handelsbanken branch manager in Wigan, who previously worked for 25 years for NatWest, outlined some of the differences between working for Handelsbanken and working for mainstream British banks.¹¹⁶ These included:

1. No longer being instructed to sell products to people he is simultaneously trying to collect debts from.
2. No central office staff telling him the 'correct' way to focus on his Wigan customers.
3. Now has multiple initial meetings with a new client, just to learn about their business.
4. No longer obliged to stick to centrally imposed protocol, for example only accepting a very limited variety of stock as collateral against loans, or making the same demands on seasonal businesses as non-seasonal businesses.

Since the financial crisis, many mainstream UK banks have also announced a strategy of increasing the number and importance of local relationship managers based in branches. We do not consider that the reacquisition of credit assessment skills at local level is an insurmountable barrier and it is possible that the localised structure of the new RBS could attract talented bank managers who want greater opportunities to exercise their professional expertise.

Ensuring capital adequacy in future

The ability for the local banks to raise extra capital must also be taken into consideration. As unowned institutions cannot raise capital by issuing shares in the financial markets, or charge cooperative membership fees; all capital comes from retained earnings. In Germany, this purist model has been retained, as it is believed that this is the best way to ensure that the savings banks model lasts. Switzerland, however, has deviated from this model to allow cantonal savings banks to raise additional capital from shareholders.

As laid out in the Swiss Federal Law on Banks and Savings Bank 1934, Swiss cantonal banks must be partly (typically majority) owned by the relevant local authority ('canton'), can only operate within the canton, and each canton can decide on the bank's ownership structure and public mandate. Their supervisory boards must 'as far as possible, reflect the different tendencies of the canton's economic and social life.'¹¹⁷

To raise additional capital, some cantonal banks also issue shares; however, cantonal banks typically put a lot of effort into ensuring that local people and businesses are the owners of any shares, for example, by offering shares to account holders before they are offered elsewhere.¹¹⁸ There are ways to give public banks greater access to capital but care must be taken to guard against distorting incentives within the bank towards delivering higher returns to shareholder and slowly erode its ability to fulfil its social mandate.

4. What would it look like?

Illustrative case studies

The essence of our proposal is to create a network of local public interest banks. We set out an illustration of what this might look like for one city and one county in the UK – Bradford and Cornwall. To provide a comparison we interviewed executives of two Sparkassen that serve similar areas in Germany – Dortmund and Landkreis Görlitz.

4.1 Sparkasse Dortmund¹¹⁹

Dortmund is a city of 575 000 inhabitants in the Rhine-Ruhr industrial heartland of Germany. Its unemployment rate of 13% it is more than twice the national average of 5%, partly as a result of the decline of the steel and coal industries. The city has sought to diversify into technology sectors, in particular in medical technology, logistics, software development and research. Its local bank, Sparkasse Dortmund, has a balance sheet of just under £7 billion of assets devoted to the economic development of the city (see Table 7).

Table 7. Key statistics for Sparkasse Dortmund

Sparkasse Dortmund	Key statistics
Total assets	€8.2 billion (£6.8 billion)
Business loans	€2.9 billion (£2.4 billion)
Personal loans	€1.7 billion (£1.4 billion)
Customer deposits	€6.4 billion (£5.3 billion)
Largest business loan	€200 million (£166 million)
Smallest business loan	€1000
Number of personal customers	323 000
Number of business customers	29 000
Number of branches	53 + 7 self-service stations
Number of employees	1700 (1300 FTE)

Working closely with businesses

Sparkasse Dortmund is subject to the same prudential regulation as any other German bank or Sparkasse by BaFin, the German financial regulator in terms of credit assessment. However they argue that they take a refined assessment of risk based on close knowledge of the local economy. Information is gathered through personal knowledge and thorough interviewing of prospective entrepreneurs. They do not give a 'yes' or 'no' judgement on a business plan upfront but see themselves as co-developers of a sound business strategy for their customers.

Supporting economic development

Their specialist Start-up Centre offers training and support in collaboration with job centres and chambers of commerce who refer people to the bank. In 2013, they financed 130 start-ups with €3.2 million of loans, an average of €24,000 per start-up.

The Sparkasse sees itself as an 'agency for regional development' and cited its role in creating Technologie Park Dortmund – a new enterprise park with 280 enterprises and 8500 employees. It was started as a joint venture between the city, chambers of commerce, private investors, and the university as well as commercial banks, local co-operative banks, and Sparkasse Dortmund. Following completion of the park, it has been Sparkasse Dortmund that has provided the most start-up capital for new enterprises.

Regional commitment

Sparkasse Dortmund considers the network structure that allows it to retain local autonomy but to share ICT and back office costs has been important for local development. In its opinion, if it had been part of a large bank headquartered in Frankfurt, it would have abandoned the Dortmund region in the 1980s with the decline of the steel and coal industries.

The so-called "regional principle", a legal obligation that applies to all German Sparkassen, ensures that each area has a local bank to champion its economy. However, these geographical boundaries are not rigidly applied to customers. Where businesses operate in a number of areas, or where citizens live in one area and work in another, they are free to bank with either savings bank.

Collaboration

The network model of the German Savings Banks Finance Group also allows for collaboration. Dortmund is the centre of competency for doing business with or within foreign markets for about 30 smaller Sparkassen in the wider region, and is able to offer more complex products, such as leasing finance, from specialist companies in the Sparkassen group.

Large loans can be shared between neighbouring Sparkassen, and Sparkassen that have demand for credit exceeding their deposit base can access surplus deposits from other savings banks or the regional Landesbanken, who act as wholesale banks for the network.

Social impact

Sparkassen are a major provider of local taxes (corporate tax is paid locally in Germany) and many employees volunteer in NGOs and clubs and associations.

4.2 Royal Bank of Bradford

Bradford is a Metropolitan City District of 523 000 inhabitants in West Yorkshire. Like Dortmund, it makes up part of a larger urban industrial zone – the Leeds-Bradford Larger Urban Zone of over 2.3 million people. Manufacturing is still a significant sector in this a city built on the wool and textiles industry, although faster-growing sectors include information technology, tourism, and retail sectors.

Also similar to Dortmund, the city has had to face the economic transformation caused by the decline of traditional industries. The area is the 16th most deprived in England, ranked by the proportion of wards in the highest 10% measured by the Index of Multiple Deprivation.¹²¹

The city is headquarters to three financial institutions that help illustrate the development of UK banking. None of them can be described as locally focused and none provide SME loans.

- The Yorkshire Building Society has grown through mergers to be the second largest building society group in the UK and is a national bank that specialises in mortgages, personal loans, and deposit taking.
- Provident Financial plc was founded to provide affordable credit to the working classes in Bradford and is now an international lender that specialises in non-standard lending (to individuals with credit profiles unsuited to high-street-bank lending). They provide credit cards and home-collected credit distributed by a network of 8000 agents. It is a shareholder owned company whose shares are traded on the London Stock Exchange.
- The Bradford & Bingley Building Society is another Bradford financial institution that has expanded beyond the city. It followed the path of growth through mergers and acquisitions and eventually demutualised in 2000. After rapidly expanding its loan book it collapsed during the 2008 financial crisis and was rescued by the government. The branches, brand, and good assets became part of Santander UK plc, a subsidiary of an international retail banking group, and the impaired assets remain on the government's books as part of UK Asset Resolution.¹²²

Rediscovering local banking

There is a CDFI in Bradford, the Business Enterprise Fund, which has been lending money to businesses unable to get lending from banks since 2005. It has £12 million in business loans outstanding.¹²³ But in the past Bradford had its own bank.

Bradford District Bank Ltd was established in 1862 by leaders in the local woollen industry as one of the first limited liability banks in the UK.¹²⁴ The bank was acquired by National Provincial & Union Bank of England in 1918 and now forms part of the RBS Group. By 1891, it had deposits of £1 million, equivalent to over £107 million in today's terms.¹²⁵

Under our proposal, the Royal Bank of Bradford would serve the metropolitan City of Bradford and comprise the existing seven branches in the area with the business and personal clients located there. What would this mean?

- It would have proforma total assets of £2.1 billion.
- Its public service mandate would allow it to maintain or even expand the branch network in the city to ensure access for all.
- It would provide bank accounts for every citizen currently unable to access one.
- There would be an executive team whose goals were entirely focused on serving the economy of Bradford and not complying with credit criteria set in London.
- It could become a major cultural sponsor in the city.
- Its supervisory board would include bank employees, representative of the citizens of Bradford nominated by the council, and representatives of other stakeholders including for example the Bradford Chamber (of commerce), University of Bradford, representatives of customers, both savers and mortgage holders, and a representative nominated by registered charities and social enterprises in the city.

4.3 Sparkasse Oberlausitz-Niederschlesien¹²⁶

The Górlitz area served by Oberlausitz-Niederschlesien is a region of 262,000 inhabitants in the south-eastern corner of Germany bordering Poland and the Czech Republic. The corporate slogans of this rural savings bank can be translated as 'The economic geography has a social dimension' and 'Sparkassen as primary contact in money matters' reflecting the public interest missions of supporting the local economy and promoting personal financial inclusion and literacy. It has 192,000 personal customers and maintains an extensive branch network covering the region (see Table 8).

Table 8. Key statistics for Sparkasse Oberlausitz

Sparkasse Oberlausitz	Key statistics
Total assets	€2.8 billion (£2.3 billion)
Business loans	€0.79 billion (£0.66 billion)
Customer deposits	€2.5 billion (£2.1 billion)
Largest business loan	€20 million
Smallest business loan	€2500
Number of personal customers	192,000
Number of business customers	11,000
Number of branches	38 + 6 self-service stations and 1 mobile branch
Number of employees	635

The way that our interviewee at the Sparkasse described their approach to lending decisions was strikingly similar to their counterparts at Sparkasse Dortmund. The first point to be emphasised is compliance with risk-rating criteria set by regulators, the same as any other German bank or Sparkasse. But again the differentiating factors are that the client is likely to be known to Sparkasse employees for many years. They most probably know each other outside the bank and probably live in the same locality. These 'soft information' factors about the client's history, their personal networks and family come into play. Our correspondent deemed these to be a real asset on top of the standard credit rating factors based on purely "technical" data.

They acknowledged that this closeness can somewhat hamper objectivity. However, the bank and its loan officers have to be commercially successful, particularly as Sparkassen have to live off their retained earnings only and cannot replace losses with new capital from private investors. For bankers, commercial success means first and foremost that loans are repaid and our interviewee argued that this absolute objective criterion sets the boundaries around the subject elements of lending decisions, because Sparkassen executive boards and loan officers are held accountable for their lending decisions.

Unlike large commercial banks that operate an 'originate and distribute' model, making loans and then selling these on to other financial investors, Sparkassen hold their loans on their own balance sheet until maturity. Bad lending decisions have nowhere to hide in small, local, transparent, and democratically accountable banks.

Sparkasse Oberlausitz-Niederschlesien also highlighted the importance of working in co-operation with other local Sparkassen and with the whole network. Examples of the benefits of this include liquidity support in times of need, co-operation in advertising, marketing, legal compliance; offering joint products such as insurance and leasing, and sharing larger loans in risky sectors such as real-estate.

4.4 Royal Bank of Cornwall (Arghanti Kernow)

Cornwall has a strong identity as a Celtic nation, although unlike Wales, Scotland, and Northern Ireland, it has no devolved political powers. With a population of 536,000, Cornwall is over twice the size of the German Gorlitz region and yet has no regional bank. As an early birthplace of the industrial revolution and a centre of mining for tin and other metals and production of china clay, Cornwall was a prosperous region. With the decline of these industries and the other mainstays of fishing and agriculture, the region has been in relative economic decline. It contains some of the most deprived areas in England together with pockets of great wealth in the coastal resorts favoured by the wealthy as holiday destinations. The GDP of Cornwall is less than 80% of the EU average, making it one of the poorest areas in the UK and the only one to qualify for EU Objective 1 grant funding for regional development.

Under our proposal, the Royal Bank of Cornwall would comprise the existing 16 branches in Cornwall with the business and personal clients located there. What would this mean?

- It would have proforma total assets of £2.2 billion.
- Its public service mandate would allow it to maintain the branch network in small towns vulnerable to branch closures by other banks unable to maintain a viable branch.
- It would provide bank accounts for every citizen currently unable to access one.
- There would be an executive team whose goals were entirely focused on serving the economy of Cornwall and not complying with credit criteria set in London.
- It could become a major cultural sponsor in the county.
- Its supervisory board would include bank employees, representative of the citizens of Cornwall nominated by the council, and representatives of other stakeholders including for example the Cornwall Chamber of Commerce and Industry, Combined Universities in Cornwall, representatives of customers, both savers and mortgage holders, and a representative nominated by registered charities and social enterprises in the county.

South West Investment Group is a CDFI based in Cornwall and has issued £15 million of loans to businesses across the south west of England since 1996. There are also five credit unions that are members of the Association of Cornish Credit Unions, jointly promoting personal savings and loans across the county.

Under the EU regional grant programme, £500 million of EU grants are due to be invested over six years. The Local Enterprise Partnership has unveiled plans to use up to 25% of this grant money to capitalise a Cornwall business investment loan fund.¹²⁸ Does this make a local RBS bank unnecessary?

If structured in the right way, regional loan funds can stimulate local bank lending rather than displace it. This is the lesson of the Bank of North Dakota (BND), a public bank wholly owned by the State of North Dakota.

The State of North Dakota has a population of just under 700,000 – of similar size to Cornwall in population terms. It also has a rural economy. BND was founded in 1919 to provide credit to farmers who were being poorly served by financiers from outside the State. The bank has capital of US\$551 million, total assets of \$6.8 billion, and made a net profit of \$94 million during 2013.¹²⁹

The bank has no branches and works in partnership with local community banks within the state. The local banks identify loans that are eligible for support by BND, and BND will provide half of the total loan to spread risk and increase the loan finance available to businesses.

5. Evaluating the alternatives

Although an extensive cost-benefit analysis is beyond the scope of this report, we set out a number of beneficial impacts that indicate the economic and social value of reforming RBS as a network of local stakeholder banks and conclude that the potential long-term increase in GDP could exceed the short-term proceeds of privatisation.

The total cash investment by the government in RBS was £45.5 billion. This cash has been long spent. It represents a historic cost that actually should not be relevant to economic decision-making which should evaluate only the future costs and benefits of the viable alternative courses of action.

Of course, it may be irrelevant to economic decision-making but it is highly relevant politically given the natural desire for the public to feel that they have recovered their money in full.

We do not dismiss political calculations, but we confine ourselves to economic analysis and in particular considering the government's first two criteria:

1. Maximise the ability of the bank to support the British economy.
2. Get the best value for money for the taxpayer.

Here we run into a potential conflict of interest for taxpayers, who can be interpreted as having two distinct interests in the future of RBS. One is as shareholders, via the government's stake. The other is as citizens with a stake in the broader prosperity of the country, including the future tax revenues that could be generated from tackling the market failures in the UK banking market identified in Section 2.2.

If the interests of taxpayers is identified entirely with maximising the share price in the short-term, in order to achieve the privatisation of RBS, this will be in conflict with the first criterion of maximising support to the British economy unless we make the quite extreme assumption that a national shareholder bank will be the only form in which RBS can support the British economy. For all the reasons we set out in Section 2 of this report, we reject this assumption and suggest instead that the decision should rest on a broader cost-benefit analysis that also includes valuing the social and environmental externalities of each option.

Therefore our recommendation is that a full government review, under independent scrutiny, be undertaken to carry out such an analysis and set out some recommendations for this process in Section 6.

We offer some preliminary conclusions in the following section based on evaluating the alternatives:

- What are the realistic prospects for proceeds of privatisation during the 2015–2020 Parliament?
- What additional impact on GDP, real economy lending, and jobs might be generated if RBS performed in line with comparative international local stakeholder banking networks?
- What other social and environmental factors might be relevant?
- Could the benefits of local stakeholder banks be achieved through organic growth of the UK community finance sector?

5.1 Prospects for RBS privatisation

Since nationalisation, RBS has taken a series of steps to improve its balance sheet and capital position. As described in Section 3.2, the current strategy is to make the bank ‘simpler, smaller and fairer’. This entails concentrating on UK retail banking, withdrawing from many overseas markets, and disposing of non-core businesses including the £29 billion of risky assets that were placed into an internal ‘bad bank’ – RBS Capital Resolution.¹³⁰

Over the year to 6 February 2015, the share price traded in the range 299p to 404p – a weekly average closing price of 349p.

According to the UKFI, the net cost of the government’s stake in RBS after taking account of agreed payment of £1.5 billion by RBS to cancel the DAS is £43.7 billion, equivalent to 482p per share.

The chances of selling the whole of the government’s stake between 2015 and 2020 at prices in excess of 482p per share seem remote for reasons we now set out:

1. Industry benchmark valuations suggest the shares are unlikely to trade above 400p per share over the next few years

The preferred valuation methodology for banks¹³¹ is based on *book value*, which is calculated as the difference between the bank’s assets and liabilities and is equivalent to the shareholders’ equity in the bank. Certain accounting items are deducted to arrive at a figure for *tangible book value* (TBV) or *tangible equity*. When the book value per share is compared with the share price, we arrive at a ratio called the *price-to-book-value ratio*, or P/BV.

At the end of 2013, RBS had TBV of £44.4 billion, or 390p per share. The share prices of European universal banks – those that have both significant investment banking and retail banking operations – trade at an average P/BV of around 1.0, meaning that the share price is approximately equal to the TBV per share.

RBS share price has been trading at below 1.0 times book value, but even if we assume it moves into line with the industry average, TBV will have to grow by over 25% to drive a share price in excess of 482p.

2. The is considerable uncertainty over future litigation costs and regulatory fines for misconduct

The list of cases of misconduct by RBS and other UK banks is long and growing. Currently RBS has made provisions for future payments of £2.7 billion for compensating customers and paying regulatory fines for the following activities:¹³²

- Compensating customers for misselling personal protection insurance (PPI) and other types of loan and credit card insurance, and interest rate hedging products.
- Fines and potential litigation costs for manipulating LIBOR and foreign exchange markets.
- Litigation by the US Federal Home Finance Agency for misselling up to \$32 billion worth of mortgage-backed securities.

Additional provisions to settle these cases might easily amount to more than £5 billion,¹³³ but until there is certainty over the final cost of all of these cases, investors will seek a greater discount on the share price to reflect taking on this additional risk.

3. The sheer size of the government's stake acts as a drag on the potential sale proceeds, and the feasible speed of the sale

For every four shares in RBS owned by the government there is only one trading on the stock exchange.¹³⁴ The existence of such a large number of shares to be sold onto the exchange at some point in the future has the effect of depressing the share price, because share prices are determined by the balance between sellers and buyers on the market. This is known as an *overhang of shares*.

In the case of RBS, this is a very significant factor. To achieve a sale of all the shares at the bail-out price of 482p would mean £43.7 billion of sales. To put this into context, the total amount of money raised on the UK stock market during 2014 was £22.59 billion, in 2013 it was £19.51 billion, and in 2012 it was £5.69 billion.¹³⁵ The largest single transaction for shares in Lloyds Bank so far has been the government's sale of 7.78% of the shares for £4.2 billion in March 2014.^{136,137}

The sheer size of the stake in RBS relative to the shares currently traded, and in relation to the ability of investors to absorb such a significant additional amount of shares implies that either the shares would have to be sold at a very attractive discount to the current trading price, or that the shares would have to be sold gradually over an extended number of years. The first sale of shares in Lloyds Bank in September 2013 for £3.2 billion was achieved at a 3% discount to prevailing market prices against an average for similar deals in 2008 of 4%.¹³⁸ This would imply that the shares would need to trade above 500p for the government to start selling its shares with no loss on the original price paid.

In conclusion, the privatisation option has considerable uncertainties about the amount of money that can be raised by the government, how soon it can be raised, and whether it is possible to avoid making a loss on the sale.

Taking a base case assumption that to sell the entire government stake during 2015 – 2020 would achieve average prices in the range of 350p to 450p, the total proceeds would be in the range of £31.7 – 40.8 billion, with a mid-point of £36.3 billion.

Share sales of this size will also involve considerable fees to City banks and advisers involved in arranging the sale. Depending on the method used, these could be as little as £60 million for a gradual sale similar to the approach with Lloyds Bank, or as much as £480 million for a larger offering based on the 1.2% fee paid to advisers and banks involved in the £1.98 billion sale of shares in Royal Mail.¹³⁹

We consider next the potential economic benefits of the proposal not to privatise the bank, but restructure it as a public interest local stakeholder banking network.

5.2 Impact of reforming RBS as a local stakeholder banking network

A comprehensive approach to deciding on the future of RBS should examine all viable alternatives rather than simply assume that privatisation represents the best long-term economic benefit for the UK. An extensive cost-benefit analysis is beyond the scope of this research but we have identified five potential overlapping areas of benefit where this proposal will provide greater economic and social benefit than privatisation:

- Impact on GDP
- Impact on jobs
- Impact on diversity and financial system resilience
- Impact on financial inclusion – branch access
- Impact on rebalancing the British economy
- Impact on public finances

We examine these in turn before turning the question of the cost to the public finances of keeping the bank in public hands.

Impact on GDP

To hypothesise the impact on GDP we use a counterfactual scenario based on the performance of banking systems following the financial crisis. Although this represents (hopefully) an unusual period, it is based on research by the European Central Bank (ECB) that identifies a positive relationship between credit growth and GDP that would also hold throughout the economic cycle.

RBS's loans to customers other than banks fell in aggregate by 5% between 2008 and 2009. By contrast, the local stakeholder banks in our northern European peer group increased credit by an average of 4%. Our first

counterfactual scenario is that RBS had performed in line with this peer group instead of contracting its lending after the crisis.

By calculating what impact this would have had on the growth in total UK bank lending to non-financial corporates between 2008 and 2009, and then using the ECB's methodology, we estimate that the UK would have benefited from an immediate additional £5.7 billion in GDP, and an additional £24.1 billion in GDP over three years.¹⁴⁰

We also made a calculation based on a secondary scenario that RBS had performed in line with German and Swiss public savings banks – the closest model to what we propose for RBS – who increased lending to businesses and householders by 6% between 2008 and 2009. In this case the UK would have benefited from an immediate additional £7.1 billion in GDP, and an additional £30.5 billion in GDP over three years.¹⁴¹ Detailed calculations are set out in Appendix A4.

Given that approximately 36% of GDP is collected as tax revenue,¹⁴² there would have been a direct immediate boost to public finances in these scenarios. To this can be added savings in welfare costs from reduced unemployment and associated benefit payments which we have not attempted to calculate, in addition to the ongoing impact beyond the three-year period calculated.

There are of course many factors differentiating economic performance between these countries other than the presence of local stakeholder banking networks, and it might plausibly be argued that the strength of SME export sectors in both Germany and Switzerland, for example, enabled them to turn additional credit into production and GDP growth in a way that is less likely to happen in the UK.

However, it might equally plausibly be argued that banking structures in those countries, where local banks develop long-term supportive relationships with SMEs within their regions, is a contributory factor in the strength of their SME sectors.

The theoretical and empirical case for why and how local stakeholder banks address market failures in retail banking strongly suggests that increasing this sector within the UK will increase economic activity by funding investment that would otherwise not take place.

Impact on jobs

Corporate restructuring can often lead to a reduction in the number of employees to reduce costs but this proposal for RBS is not a typical restructure. The public service mandate is intended to tackle market failures in banking that leave difficult and less profitable markets and customers unserved. Often these markets are more costly to serve precisely because more staff resources are required beyond the levels that shareholder banks are willing to commit.

Let us use a simple indicator: comparing the number of jobs in large bank with local stakeholder banks in five European countries. As shown in Table 9, in all countries except Switzerland, large banks expect their staff to individually take

responsibility for significantly more retail and business customers than in local banks. This implies that the markets served by smaller banks are more labour intensive in terms of customer service and also that smaller banks typically hire proportionately more staff. Therefore we conclude that the restructured RBS will be more likely to increase or maintain staffing levels than cut them.

Table 9. Staffing levels in different banks

Bank	Country	Type	Number of customers per staff member
Deutsche Bank (retail & business banking)	Germany	Commercial	697
Commerzbank (retail & business banking)	Germany	Commercial	695
Lloyds (retail & business banking)	UK	Commercial	621
RBS (retail & business banking)	UK	Commercial	611
ING Bank (retail & business banking)	Netherlands	Commercial	603
Cooperative Bank	UK	Commercial	485
Barclays (retail & business banking)	UK	Commercial	453
Raiffeisen	Switzerland	Cooperative	425
HSBC (retail & business banking)	UK	Commercial	387
Nationwide	UK	Mutual	370
Sparkassen	Austria	Public	311
Rabobank Group (retail & business banking)	Netherlands	Cooperative	258
UBS (retail & business banking)	Switzerland	Commercial	236
Sparkassen	Germany	Public	188
Deutschen Volksbanken und Raiffeisenbanken (BVR)	Germany	Cooperative	187
Osterreichische Raiffeisenbanken	Austria	Cooperative	138
Osterreichischer Genossenschaftsverband	Austria	Cooperative	116
Cantonal banks	Switzerland	Public	112
Credit Suisse (retail & business banking)	Switzerland	Commercial	73

Key

	local banks
	previously local banks that have had their geographical restrictions removed
	large banks

Source: NEF calculations from Bank Annual Reports and central bank data

It is also important to consider the quality of jobs, not just their quantity. When decision-making is devolved to the local level rather than centralised to head offices, employees have more autonomy, responsibility, and opportunities to develop new skills. Each of the 130 banks will require senior management and a range of skilled professional staff from human resources to lawyers and accountants. Local banking should thus also be viewed as an opportunity to help provide good job opportunities outside of London.

The decentralisation of the retail bank into 130 autonomous units is more similar to a demerger, even though back-office functions will remain combined centrally. There is little academic research exploring the link between demergers and jobs, but studies do observe the impact of poor communication with employees in creating uncertainty leading to staff looking for work elsewhere.¹⁴³ Such HR problems were observable, for example, in the 2011 Kraft demerger.¹⁴⁴ These are important operational considerations that, as a model stakeholder organisation, the new RBS should seek to apply best practice in employee consultation and involvement.

Impact on diversity and financial system resilience

We discussed in Section 2.2 how the concept of financial system resilience is gaining attention as a discrete policy goal. One of the key components of financial system resilience is greater diversity of banking institutions¹⁴⁵ – also named as an objective of government policy.¹⁴⁶ However, as also discussed in Section 2, the UK banking system is currently very homogenous, not just in terms of its lack of localism, but also with regard to different ownership models.

Changing the ownership and governance structure of RBS, which, as of 2010, had 16% of the personal current account market, 10% of the savings markets, 7% of the mortgage market, and 9% of the unsecured personal loans market,¹⁴⁷ would make significant headway towards greater diversity of incentives and business models in banking. This is because the bank would have a different strategy and objectives from its private commercial bank counterparts.

Using the index of diversity in financial services (D-Index) developed by Professors Michie and Oughton we find that diversity in the savings and mortgage markets have both declined by around 20% from the peak in 2004.¹⁴⁸ The measure of diversity has four components:

1. The size and number of firms in the market (concentration).
2. Who they are owned by and run for (ownership).
3. The sources of their funding (funding).
4. And where they are located in the UK (location).

There are a number of reasons for the decline in diversity over the last decade. Many overseas specialist mortgage providers left the UK market after the financial crisis. The merger of HBOS with Lloyds Banking Group removed a significant bank headquartered outside London, reducing location diversity,

and the sale by the Co-operative Group of a majority stake in its banking subsidiary, Co-operative Bank PLC, to private shareholders significantly reduced diversity of ownership.

The reform of RBS into local stakeholder banks would have a significant impact on the ownership and location components. It would lead to a 20% improvement in the ownership component of the index, and overall would restore a significant amount of the diversity in banking that has been lost since the financial crisis.

Impact on financial inclusion – branch access

Changes in technology and consumer preferences have led to a decline in the frequency with which customers use branches to conduct basic banking transactions. Accordingly all the major banks have been closing branches, with the total UK network almost halving in size since 1990 and reduced by 17% since 2004.¹⁴⁹

Thousands of communities have no access to any bank branch and many thousands more have only one bank left in town. This leaves the UK with only around one-third of the number of bank branches per person than key European countries.¹⁵⁰

However, branches are far from redundant. The Competition and Markets Authority concluded that even as they make more use of digital banking, an extensive branch network is still an important factor for customers.¹⁵¹

Furthermore, branch closures have adverse effects on certain interest groups, and also have negative broader economic, social, and environmental impacts, and so there is a strong public interest in maintaining branch coverage.

- Small businesses incur additional costs and inconvenience in having to travel further to carry out daily banking transactions.
- Vulnerable groups such as the elderly and the disabled find it more difficult to access banking services without a local branch.
- Excluding low-income customers from mainstream banks leads to restricting their participation in the economy and makes them more vulnerable to high-cost credit and cash-withdrawal services.
- Bank branch closures contribute to commercial decline of communities as better off consumers change their purchasing habits along with the need to travel further afield for banking services. Businesses close, re-generation is rendered more unlikely, and start-up finance for local business becomes more difficult to obtain.
- Actions taken by consumers to overcome the problems caused directly and indirectly by bank branch closures contribute to environmental damage, for example, through increasing motor vehicle usage.

National shareholder banks act rationally when they seek to cut their branch networks, but the aggregate impact on the economy is harmful.

The public service mandate we propose for RBS will give it the corporate mission and financial structure that will enable it to fulfil the public interest in maintaining universal branch coverage throughout the UK. It can allow customers of other banks to use its branch network for transactions requiring a physical presence.

Impact on rebalancing the British economy

The UK has the most unbalanced economy of any European country in terms of differences between regional economies.¹⁵² One of the key parts of the public service mandate of the new local RBS banks is to act in the best interests of the local businesses, and to have a strong commitment to the local economy.

This factor is, in a sense, a cumulative result of those outlined above. In addition, the different customer focus of local stakeholder banking networks would entail a reweighting of RBS's capital away from supporting credit to financial services and commercial property sectors, where London dominates, and towards lending for investment in production sectors such as manufacturing, retailing and distribution, telecoms, construction, and energy, which are more distributed throughout the regions of the UK.

Based on the financial support given by German savings banks to social, cultural, and sporting projects within the area they serve, it is reasonable to project that the reformed RBS would also assist in an expansion in these areas outside London in a way that is financially sustainable and not dependent on continuous grant funding from central government.

Impact on public finances

The most appropriate way to calculate the cost of keeping RBS in public hands is to estimate the foregone revenues from selling the shares. In Section 5.1 we estimate the high end of the range to be £40.8 billion. However, this sum is not equivalent to other government revenue, such as tax receipts, which are used to fund public services. In other words, the proceeds of privatisation will not be used to pay for more teachers, doctors, schools, hospitals or social care. The government has indicated that all proceeds from sales of bank shares will be used to repay public debt.

Therefore the ongoing impact of privatisation would be the savings in interest payments of £40.8 billion of government debt. The UK government is currently able to borrow at very low interest rates, as shown in Table 10:

Table 10. Government borrowing costs

Term of borrowing	Yield to maturity	Annual interest cost of £40.8 billion government debt (£ million)
2 years	0.42%	171.36
5 years	1.13%	461.04
10 years	1.66%	677.28
30 years	2.37%	966.96

Source: Bloomberg¹⁵³

The interest rate on 10-year gilts is often used as a benchmark for the return that investors are willing to accept for long-term 'risk-free' investments.

On this basis, the benefits of privatisation to the public finances would be around £677 million per year. Even using the longer term 30 year rate of 2.37% leads to an ongoing annual cost of under £1 billion.

Therefore the test for alternative proposals, such as the one set out in this publication, is whether the additional economic and social value created will result in additional tax revenues, and public expenditure savings, of more than £677 million a year. If this test is met for the first few years it will be met permanently because the net benefits of reforming RBS will increase annually with inflation and economic growth while the value of the foregone proceeds from privatisation remains constant.¹⁵⁴

5.3 Organic growth of local banks

Can we have the best of both worlds by privatising RBS while encouraging the organic growth of alternative lenders to address the market failures set out earlier in this report? We consider the potential of the credit union sector, CDFIs, and other local banking innovations to provide the kinds of benefits of local stakeholder banks set out in Section 2.

Local banking innovations

There are a range of initiatives to set up locally focused lending institutions to meet funding gaps for small businesses and individuals.

- **Hampshire Community Bank.** This local multi-stakeholder, not-for-profit bank will offer a full range of high-street banking products to citizens and SMEs in Hampshire modelled on German savings banks (Sparkassen). It plans to launch in spring/summer 2015 and is in the process of raising capital and applying for a full banking licence.
- **Cambridgeshire & Counties Bank (CCB).** Owned by Cambridgeshire Local Government Pension Fund and Trinity Hall, a college of the University of Cambridge, CCB focuses on loans and other banking services for SMEs, including social enterprises and charities from anywhere in the UK. The loan book had reached £200 million by 30 June 2014.
- **Bank of Bournemouth.** Since June 2014, Bournemouth Council has been lending its own reserves to micro and small businesses within its area. There is a commitment of up to £15 million from the council with a plan to also provide mortgages in the future.
- **Lancashire County Council/Funding Circle.** A crowd-funding model allowing individuals to lend directly to local SMEs using Funding Circle's technology platform, and the partner council who invests money in the platform that is ring-fenced for SME lending within its area. Lancashire firms were lent £2 million in the first eight months.

Peer-to-peer lending

The peer-to-peer (P2P) sector is growing rapidly in the UK. Some £1.02 billion was loaned to businesses and £547 million to individuals.¹⁵⁵ Around 1 in 3 P2P borrowers say they would not have been able to access credit from traditional banks.

P2P platforms and borrowers and lenders are spread around the different regions of the UK, although few focus specifically on particular geographic areas, being more likely to specialise in particular types of financing, for example invoice factoring.

Rapid growth is expected to continue with new developments in this area including investment from large institutional investors such as hedge funds and wealth managers, as well as individuals wishing to lend their surplus cash. These are now said to account for over half of all loans made via the US platform Lending Club.¹⁵⁶ Another trend in the USA is for P2P platforms to make loans themselves and issue lenders with notes backed by the income stream from the loans, using a special purpose vehicle.¹⁵⁷

Community Development Finance Institutions (CDFIs)

CDFIs are specialised financial institutions whose mission is to provide financial products and services to people, communities and businesses underserved by traditional financial markets. The US Treasury's CDFI fund has 808 registered CDFIs with total assets of USD 64.3 billion,¹⁵⁸ which is a conservative estimate of the total size of the CDFI sector.¹⁵⁹ By comparison, in the UK we have approximately 60 CDFIs¹⁶⁰ with total loans outstanding of £204.7 million,¹⁶¹ giving an average loan book size of £3.4 million. In other words, to reach a similar scale to the US industry relative to the size of the economy, the UK CDFI sector would have to be well over 30 times larger in terms of assets.

American CDFIs have largely flourished as a result of the Community Reinvestment Act (CRA).¹⁶² This legislation, introduced in 1977, makes it mandatory for banks to ensure that all members of the communities in which they operate are given *appropriate* access to credit, even those on low incomes. Large banks often fulfil CRA obligations by lending to CDFIs who, in turn, lend to low-income communities. Despite lending in low-income communities, research has shown that CDFI lending driven by the CRA was not a contributory factor to the 2008 sub-prime mortgage crisis.¹⁶³

Credit unions

There are significant barriers to growth in the UK credit union movement. It is not organised as a network as in other countries with economically significant credit union sectors.¹⁶⁴ Many British credit unions are significantly dependent on grant funding or support from local authorities, with 80% of community-based credit unions having received some form of grant funding.¹⁶⁵ They cannot access the payment systems directly and face prohibitive charges to offer customer current accounts and debit cards.¹⁶⁶ In addition, many members still have to visit their credit union contact point in person to be able to withdraw money, because their credit union cannot provide access to ATMs or internet banking.

Steps are being made towards attempting to create a centralised infrastructure for credit unions in the UK. The Department for Work and Pensions (DWP) awarded £38 million to ABCUL, the trade group representing British credit unions, to help modernise and grow the credit unions sector, including by developing a central IT platform.¹⁶⁷ Successful delivery of this expansion project would still leave British credit unions well short of the central liquidity services, mutual guarantee scheme, access to wholesale banking markets, and product development expertise that many of their overseas counterparts enjoy.

In the UK they primarily offer savings accounts and unsecured personal loans. A select few also offer mortgages, and, since January 2012, credit unions are allowed to offer business loans. However, to date, none have elected to do so, most probably because they lack the expertise and capacity to offer such services. Furthermore, individual loans are restricted to a maximum of £15,000 for some credit unions and £7,500 or lower for many others. The UK government has also relaxed the law around the common bond requirement, to make it less restrictive by international standards.

However, restrictions on credit unions activities need to be loosened further to bring the UK in line with other countries.¹⁶⁸ Regulations surrounding Canadian credit unions were relaxed in the 1970s and 1980s allowing them to offer a broad range of high-street banking services. US credit unions have been offering mortgages since 1977, and business loans since 1998.¹⁶⁹ The broader spread and larger sizes of loans in these countries makes a significant difference to their financial viability.

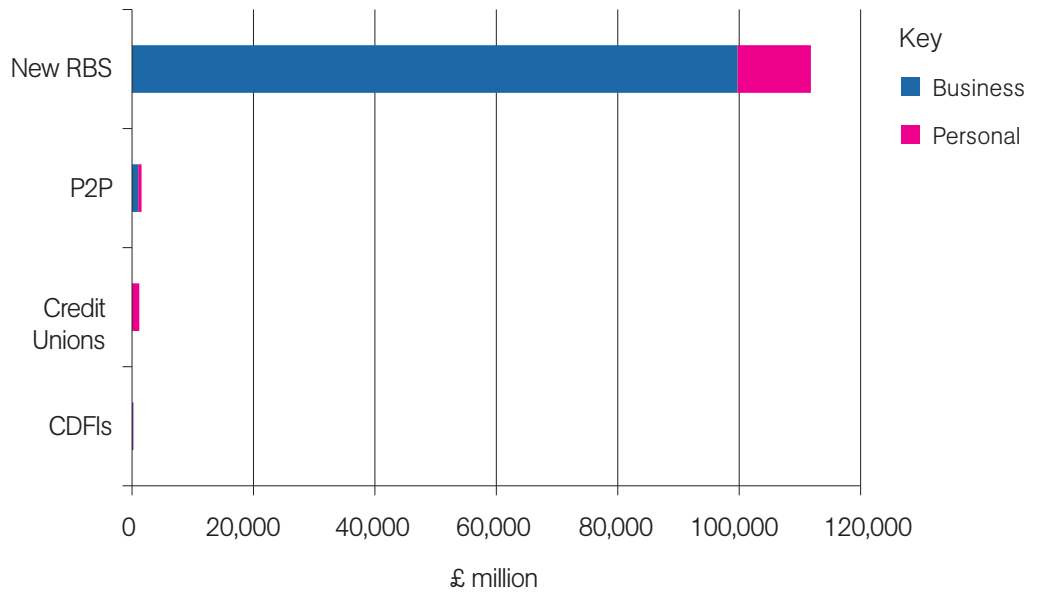
5.4 Conclusions – ‘and’ not ‘or’

The credit union sector has been expanding in the UK and broadening its reach; the CDFI industry has also expanded since the financial crisis; and the P2P lending sector is expanding rapidly, particularly in the SME market. As we have discussed above, there are local innovations around the UK that are potential sources of growth in local stakeholder banks.

The relative scale of these alternative sources of finance should be put in context. After our proposed disposals of non-core parts of RBS, we project that it would have total loans outstanding to businesses of £99.7 billion and unsecured personal lending of £12.1 billion. Mortgages of £102.7 billion make up the rest of the UK loan book.

As shown in Figure 13, this is two orders of magnitude, in other words a factor of 100 times, larger than the P2P, CDFI, and credit union sectors put together.

Figure 13. Relative size of alternative finance sectors and RBS



Sources: NESTA, ABCUL, CDFA, RBS Results and NEF calculations

Furthermore, although the fastest growing segment – the P2P industry – has the potential to help address market failure in the market for SME credit, it does not have a social mission or offer the benefits of maintaining branch access in the way that the RBS proposal does.

Despite promising growth and development in all these sectors, it will be some considerable time before they represent a significant challenge to incumbent banks in terms of locally focused lending. Therefore we see the development of community finance and new technology driven business models such as P2P lending as being welcome complements to high-street banking, but not replacements for it. Indeed, to the extent that the P2P industry is able to take profitable business from banks, it may speed their withdrawal from the high street in less affluent and sparsely populated areas of the country.

6. Recommendations

The most important conclusion of this report is that the government should undertake a full evaluation of all the options for RBS and not simply assume that privatisation is in the best interests of the UK. We believe the theoretical and empirical case for such a full evaluation is too strong to ignore, and failure to carry out such a review would represent a lack of due diligence by the government in taking such a significant financial and economic decision.

We have set out theoretical and empirical evidence to suggest that the creation of a local stakeholder banking network with a public interest mandate could bring greater economic and social benefits than privatising RBS.

Creating a local stakeholder bank

The key features of the proposal are as follows:

- The government would purchase the remaining minority interest shares in RBS to take complete control for a transitional phase.
- The Corporate & Institutional Banking and Private Banking divisions should be divested, and the capital realised used to repay the cost of buying out the minority interest and to bolster the bank's capital position.
- The bank would be separated into between 100 and 150 local banks in England, based on local authority areas and subject to consultation.
- The local banks would operate as a network, with a mutual guarantee scheme based on the German savings bank model.
- Central functions such as IT, training, marketing, regulatory compliance, public affairs, liquidity management, and specialist financial services would be retained in a group entity jointly owned by the member local banks.
- The degree of decentralisation for the Scottish and Welsh parts, and Ulster Bank, would be a matter for their respective national governments.
- Each local bank would be placed in trust for the public benefit with a supervisory trustee board comprising representatives of staff, customers, citizens through their elected representatives, and other stakeholders such as Chambers of Commerce, social enterprises and charities.
- The operating board of the bank would comprise only professional bankers and would be held to account for delivering both sound financial and social returns in line with the bank's public interest mandate.

Evaluation criteria

In summary, we argue that future of RBS should be judged on a number of social and economic criteria and not just on the narrow criterion of maximising cash receipts to the government in the short-term. We summarise the comparative benefits of the two options in Table 11.

Table 11. Comparing benefits of privatisation and public interest local stakeholder banks

Benefits of privatisation	Benefits of local stakeholder banks with public interest mandate
Reduction in ongoing interest costs of c. £677 million per year resulting from repayment of c. £40 billion of government debt	Increased GDP and associated tax revenues. For the scenario, analysis is based on comparative growth in credit following the financial crisis the impact is of the order of £24.1 billion to £30.5 billion additional GDP over three years.
	Investment in higher staff-to-customer ratio by local stakeholder banks would lead to additional jobs with consequent tax revenues, saved welfare and benefit costs, and social benefits.
	Significant increase in diversity and resilience of the UK banking system, offering greater protection to the economy to future economic shocks
	Access to a current account for all UK citizens, and maintenance of universal branch coverage across the UK.
	Increased investment and economic development, as well as financial support for social, cultural, and sporting activities in UK regions outside London.

Our preliminary analysis suggests that, compared with privatisation, reforming RBS as a local stakeholder banking network would better satisfy the government's objectives to:

1. Maximise the ability of the banks to support the British economy.
2. Get the best value for money for the taxpayer.

However, to properly assess this would require a comprehensive cost-benefit analysis to be carried out.

Next steps

In order to preserve the fullest range of options, it is essential that the new government in May 2015 takes two immediate steps:

- Announce that no shares will be sold until a full review into the future of RBS has been carried out.
- Impose a moratorium on branch closures.

It should then set up an independent commission to carry out a broad and comprehensive cost-benefit analysis of privatisation versus an alternative for a public interest bank along the lines proposed in this report. The initial consultation period might allow for alternative proposals to be put forward.

Ideally the terms of reference for the commission, including its composition, would be drawn up in consultation with opposition parties to try to achieve cross-party support for a fair process. However, we recommend that the commission also include stakeholder representatives such as trade unions, business groups, customer representatives, regulators, charities and social enterprises, local authority representatives, and citizens.

Concluding remarks – rebuilding trust through engaging citizens

Our final thought on why the UK, and RBS itself, would benefit from the creation of a public interest bank relates to the erosion of public trust in banking institutions following the financial crisis.

We suggest that presenting people with the choice of a genuinely local bank that has an explicit mandate to serve the public interest, and includes stakeholders on its supervisory board, can be an important component in rebuilding trust in the whole banking system.

Citizens should be positively engaged with the important economic institutions that have an impact on their lives. Stakeholder boards can not only serve a democratic representative and supervisory purpose, but also provide a flow of useful intelligence into the bank to enable it to perform at its best.

Equally importantly, it can act as a conduit for better understanding and appreciation of banks and bankers as a whole among the general population, and rebuild belief that banking is a force for good in society.

Reforming RBS as a citizens' bank would not only create a major institution built on principles of greater accountability and transparency, it would also champion a pluralistic view of the corporate sector that celebrates the achievement of social goals in harmony, rather than in conflict, with the making of profits.

Appendices

A1. Allocation of RBS assets

Estimates of the assets to be retained in the new RBS Group and those that should be sold are based on the following assumptions:

- 50% of central assets and liabilities would be retained and 50% would relate to the sold businesses. This is in line with the allocation of central costs to the divisions in RBS accounts.
- 5% of corporate and investment banking would be retained to reflect the financial trading requirements of the UK retail and commercial bank.

Table A1. Allocation of RBS assets and liabilities to new bank

£ billion	Personal and Business Banking	Ulster Bank	Commercial Banking	Central items	Commercial and Institutional Banking	Williams & Glynn	Total New
Proportion of balance sheet retained/(sold)	100%	100%	100%	50%	5%	-100%	
Mortgages							104.4
Personal unsecured							12.3
Business							101.4
Net loans and advances to customers	127.0	22.0	85.0	0.2	3.6	19.7	218.1
Other assets	7.2	4.3	4.7	43.6	10.1	3.4	66.5
Funded assets	134.2	26.3	89.7	43.8	13.7	23.1	284.6
Derivatives	-	0.2	-	1.0	14.9	-	16.1
Total assets	134.2	26.5	89.7	44.8	28.6	23.1	300.7
				0	0		
Customer deposits	146.0	19.7	87.0	(3.1)	3.3	22.2	230.7
Deposits/loans	1.1	0.9	1.0	-	0.0	113%	1.1
				-	-		
Risk-weighted assets (3)	44.7	23.9	64.9	8.9	6.2	7.7	140.9
Capital (nominal)	5.4	2.9	7.8	1.1	0.7	0.9	16.9

	Private Banking	Citizens 100%	RBS Capital Resolution	Central Items	CIB	Divested RBS divisions
Proportion of balance sheet sold	100%	100%	100%	50%	95%	
Net loans and advances to customers	16.7	55.7	13.2	0.4	69.3	155.3
Other assets	4.3	24.8	4.7	43.6	191.9	269.3
Funded assets	21.0	80.6	17.9	44.0	261.2	424.6
Derivatives	0.1	0.3	13.4	100.0	283.1	396.9
Total assets	21.1	80.9	31.3	144.0	544.3	821.6
					0	-
Customer deposits	36.2	57.0	-	(6.1)	62.3	149.4
Deposits/loans	217%	102%			0.9	4.0
					-	-
Risk-weighted assets (3)	12.2	64.4	30.6	-	117.0	224.3
Capital (nominal)	1.5	7.7	3.7	-	14.0	26.9

A2. List of local authorities in England by type

Table A2. List of local authorities in England by type

Shire Counties (27)	Unitary Authorities (55)	Metropolitan Counties (6)	London Boroughs (32)
Buckinghamshire	Bath and North East	(1) Greater Manchester:	Barking and Dagenham
Cambridgeshire	Somerset	Bolton Bury Manchester	Barnet
Cumbria	Bedford	Oldham Rochdale Salford	Bexley
Derbyshire	Blackburn with Darwen	Stockport Tameside Trafford	Brent
Devon	Blackpool	Wigan	Bromley
Dorset	Bournemouth		Camden
East Sussex	Bracknell Forest	(2) Merseyside:	Croydon
Essex	Brighton and Hove	Knowsley Liverpool Sefton	Ealing
Gloucestershire	Bristol	St Helens Wirral	Enfield
Hampshire	Central Bedfordshire		Greenwich
Hertfordshire	Cheshire East	(3) South Yorkshire:	Hackney
Kent	Cheshire West and Chester	Barnsley Doncaster Rother-	Hammersmith and Fulham
Lancashire	Cornwall	ham Sheffield	Haringey
Leicestershire	County Durham		Harrow
Lincolnshire	Derby	(4) Tyne and Wear:	Havering
Norfolk	Darlington	Gateshead Newcastle upon	Hillingdon
Northamptonshire	East Riding of Yorkshire	Tyne North Tyneside South	Hounslow
North Yorkshire	Halton	Tyneside Sunderland	Islington
Nottinghamshire	Hartlepool		Kensington and Chelsea
Oxfordshire	Herefordshire	(5) West Midlands:	Kingston upon Thames
Somerset	Isle of Wight	Birmingham Coventry	Lambeth
Staffordshire	Kingston upon Hull	Dudley Sandwell Solihull	Lewisham
Suffolk	Leicester	Walsall Wolverhampton	Merton
Surrey	Luton		Newham
Warwickshire	Medway	(6) West Yorkshire:	Redbridge
West Sussex	Middlesbrough	Bradford Calderdale	Richmond upon Thames
Worcestershire	Milton Keynes	Kirklees Leeds Wakefield	Southwark
	North East Lincolnshire		Sutton
	North Lincolnshire		Tower Hamlets
	North Somerset		Waltham Forest Wands-
	Northumberland		worth
	Nottingham		Westminster
	Peterborough		
	Plymouth		
	Poole		
	Portsmouth		
	Reading		
	Redcar and Cleveland		
	Rutland		
	Slough		
	Southampton		
	Southend-on-Sea		
	South Gloucestershire		
	Stockton-on-Tees		
	Stoke-on-Trent		
	Shropshire		
	Swindon		
	Telford and Wrekin		
	Thurrock		
	Torbay		
	Warrington		
	West Berkshire		
	Wiltshire		
	Windsor and Maidenhead		
	Wokingham		
	York		

Note: City of London Corporation is excluded, and Isles of Scilly are assumed to combine with Cornwall.

A3. Whatever happened to the real Trustee Savings Banks?

In 1976, 20% of the UK population had an account at a Trustee Savings Bank¹⁷⁰ and yet by 1986 the sector had been transformed into a single national shareholder bank and in 1995 it finally disappeared in a merger with Lloyds Bank. The national shareholder-owned bank called TSB that was spun out of Lloyds Banking Group in order to comply with EU state aid regulations bears no resemblance to the original Trustee Savings Banks, other than its brand name.

Trustee Savings Banks (TSBs) were first legally recognised in the UK in 1817. They started in Scotland, but swiftly became popular institutions across the country. They were typically established by philanthropists for the purpose of fostering thrift amongst those on lower incomes, and had a very conservative model of reinvesting savings in government bonds.

These savings were unowned but managed by trustees, and there was typically not more than one of these TSBs in any given area.

In the 1970s, the Conservative government under Ted Heath appointed the Page Committee on National Savings. The Committee recommended radical changes in the TSBs' structure, in the services which they offered, and in their relationship with the government. The Committee argued that TSBs should be 'expected it to stand on their own feet financially and be brought into more equal competition with other banks'¹⁷¹ and building societies to become 'a third force in banking'.¹⁷²

As a result, restrictions were lifted to allow TSBs to offer loans rather than simply invest in government securities. To address concerns that the trustee structure made it hard to raise capital for expansion, the sector was encouraged to consolidate through mergers. The number of TSBs fell from 75 in 1970 to 17 in 1976.¹⁷³

The Page report indicated that the TSBs should eventually become mutuals that would be structured around regions but these conditions were not incorporated into the Trustee Savings Banks Act of 1975 which also specified that a central co-ordinating authority or Central Board should be created for the TSBs, to which trustees ceded some of their powers.

By 1984, a second wave of mergers created a single national entity called the TSB Group, with the Central Board entering discussions with the government. In 1986, the group was privatised by a sale of shares on the London Stock Exchange and became like any other national shareholder owned bank.

This move was highly controversial for three reasons:

1. As the banks were unowned, there were extensive legal disagreements about whether or not depositors, the state, or the bank itself should lay claim to proceeds of the sale of shares. In the end, the courts ruled in favour of the latter, and the money raised was kept as an equity cushion in the new bank.

2. Critics argued that the government did not have the right to decide that the TSB Group should be privatised. Depositors fought the flotation in general on the grounds that if they were proven to be the owners, then it would be illegal for the government to sell the bank.¹⁷⁴ In short, depositors claimed that because no one owned TSB, they should be considered owners, over the government's claim at least – but the government won in the courts.
3. Concerns were raised about how close the government had become to the Central Board, for example, due to the high frequency of meetings.¹⁷⁵ Similarly, eyebrows were raised when the former Economic Secretary to the Treasury from April 1981 to 1983 was appointed as a director of the Central Board in 1985.¹⁷⁶

Unfortunately, the bank did not flourish after privatisation. The shares were widely believed to have been undervalued on privatisation, and the bank therefore did not raise capital it could have. The Group was eventually merged with Lloyds Bank in 1995.

Only one TSB, the Airdrie Savings Bank, survived this process to remain an independent trustee bank and so, after flourishing for 150 years, the UK lost its local public trust savings banks.

A4. Calculation of impact on GDP and SME credit

We compare the difference in credit provision between stakeholder banks and large commercial banks after the financial crisis across six countries, including the UK. The countries range in size, with the UK being in the middle of the range, and are Japan, Germany, Switzerland, Austria, and Finland. By using the results of previous studies of the link between GDP and bank lending, we are able to project a range of the potential uplift to GDP that the UK would have experienced if we had had a local stakeholder banking sector comparable to these other countries.

In 2010, in light of the financial crisis, the ECB attempted to quantify the link between bank lending and GDP.¹⁷⁷ This is not an easy task because of simultaneous causality, i.e., the fact that lending impacts on GDP and vice versa make it difficult to use econometric techniques to isolate the direction of the causal relationship. However, using country-level money-demand shocks – which correlate with loan supply but not output or loan demand – as an instrumental variable, the ECB is able to estimate the impact, given the fixed exchange rate regime and centralised monetary policy of the Eurozone.¹⁷⁸

Its methodology relies on businesses not being able to perfectly substitute bank loans for other forms of financing, such as equity or bond issuance. For example, similar studies looking at the US, which is less dependent on bank loans than the Eurozone, have not found a statistically significant causal relationship between bank lending and GDP.¹⁷⁹ As one can see from Table A3, the UK lies somewhere in between the Eurozone and the USA – the UK and the Eurozone are similarly dependent on bank loans; however, the UK also has very well developed capital markets like the USA.

Table A3. Debt vs equity finance in the USA, the UK, and the Eurozone

	(bank loans to private sector)/GDP	(outstanding bonds and shares)/GDP
UK	134%	349%
Eurozone	131%	163%
USA	61%	327%

Source: NEF calculations from World Bank and central bank data

Small businesses are particularly reliant on bank financing, as they are too small to access the global capital markets. However, a similar picture emerges when looking at the three economic areas under this lens (Table A4) – the UK lies in the middle of the Eurozone and the USA when it comes to a dependence on SMEs.

Table A4. Proportion of employment by SMEs in the USA, the UK, and the Eurozone

	Percentage of private sector workforce employed by SMEs
UK	59%
Eurozone	67%
US	49%

Source: World Bank data

However, as a Bank of England study concluded that ‘The theoretical and empirical finance literature suggests that loans from intermediaries are not perfect substitutes for securities offerings,’¹⁸⁰ we will proceed with the ECB’s methodology, whilst acknowledging that it will give us an imperfect estimate, as it used Eurozone rather than UK data.

Using panel regressions (i.e., looking at data across multiple countries and through time), the ECB determined that the immediate impact of a decrease in bank lending is:

$$\begin{aligned} &\% \text{ reduction in GDP growth below Eurozone average} \\ &= (\% \text{ decrease in credit growth below Eurozone average}) * 0.077 \end{aligned}$$

The equivalent three-year multiplier effect of a decrease in bank lending is:

$$\begin{aligned} &\% \text{ reduction in GDP growth below Eurozone average} \\ &= (\% \text{ decrease in credit growth below Eurozone average}) * \frac{0.077-0.004}{1-0.456-0.322} \end{aligned}$$

Let us consider the immediate and the three-year effect of the collapse in UK bank credit from 2008 to 2009, and how this might have differed had RBS been a local stakeholder banking network.

Table A5 gives a breakdown of the average change in stakeholder bank credit to businesses between 2008 and 2009 in a variety of countries.

Table A5. Average stakeholder bank credit expansion to businesses between 2008 and 2009

	Average change in stakeholder bank credit to business between 2008 and 2009
Germany	5%
Switzerland	7%
Finland	5%
Austria	0%
Japan	2%
Average across the five countries	4%

Source: Central bank data and NEF calculations

The ECB's statistical data warehouse provides data for the 11 countries¹⁸¹ used in the ECB study, as well as the UK. The World Bank provides GDP data for all countries. Taking total lending to non-financial corporates and GDP data from 2008 and 2009, we can calculate average Eurozone and UK lending and GDP growth rates over the time period.

By calculating what impact this would have had on the growth in total UK bank lending to non-financial corporates between 2008 and 2009, and then using the ECB's methodology, we estimate that the UK would have benefited from an immediate additional £5.7 billion in GDP, and an additional £24.1 billion in GDP over three years.¹⁸² Taking on board the 95% confidence intervals quoted in the ECB's research, we can quote a £0.5–10.8 billion range for the short-term impact, and a £3.1–225.7 billion range for the three-year impact.

We also made a calculation based on a secondary scenario that RBS had performed in line with German and Swiss public savings banks – the closest model to what we propose for RBS – who increased lending to businesses and households by 6% between 2008 and 2009. In this case, the UK would have benefited from an immediate additional £7.1 billion in GDP, and an additional £30.5 billion in GDP over three years.¹⁸³ Again, using the 95% confidence intervals quoted in the ECB's research, we can quote a £0.6–13.7 billion range for the short-term impact, and a £3.9–285.1 billion range for the three-year impact.

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This research was made possible by generous support from The Joseph Rowntree Charitable Trust and The Tedworth Charitable Trust.

Written by: Tony Greenham and Lydia Prieg. With contributions from Leander Bindewald, Alice Martin and Josh Ryan-Collins.

Edited by: Mary Murphy

Designed by: danfarleydesign.co.uk

Cover image: fourthandfifteen via flickr (CC BY-NC-ND 2.0)

New Economics Foundation

www.neweconomics.org

info@neweconomics.org

+44 (0)20 7820 6300

@NEF



Registered charity number 1055254

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ISBN 978-1-908506-76-4



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