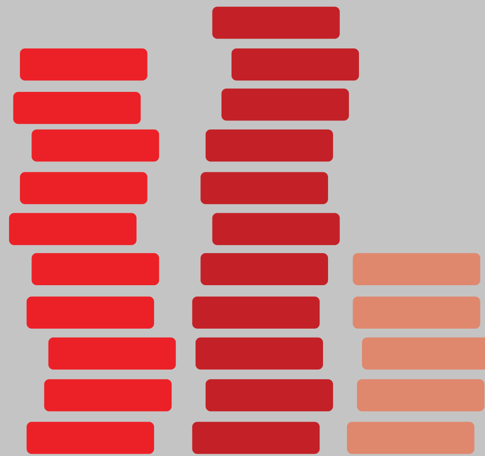

Good Banking

Why we need a bigger public debate on financial reform

The report of the Good Banking Summit

"The New Economics Foundation and Compass brought together a diverse and passionate coalition to formulate an agenda for banking reform. Its determination and energy had something of the flavour of the early meetings of the debt relief campaign for the developing world in the 90s."

The Guardian, 30 May 2011

Contents

Introduction and summary:
Why we need a bigger public debate on financial reform **1**

Setting the scene **4**

Victoria Chick, Emeritus Professor at University College London 4

Alex Brummer, City editor of *The Daily Mail* 4

Will Hutton, The Work Foundation 5

Chuka Umunna MP, Shadow Minister for Small Business and Enterprise 6

Commentary On the task of the Independent Commission on Banking (ICB) **7**

Reports of the working groups **10**

The separation of casino-style investment banking and retail banking: why and how it should be done 10

The case for breaking up banks 11

Pay, risk and perverse incentives: getting the signals right 12

Optimal taxation: the quid pro quo for public underpinning of the banks 13

Monetary Reform and Capital controls: how understanding money creation shapes bank reform and reconciling democracy and the markets 14

Assessing the assessors: the role of accountants and credit ratings agencies in bank failure and what should be done 17

Transparency and democracy: how to address the power of the bank lobby 19

Universal Obligations and fair finance: meeting everyone's needs 20

Institutions: from a Post Bank to a Green Investment Bank, what new banking architecture is needed? 21

Localisation and competition: are banks able to meet the needs of business and industry? 23

Banking for economic transition: are banks fit for the future and can pension funds demonstrate 'efficient' allocation over time? 26

The Good Banking Summit and the Good Banking Forum **28**

Participants **29**

Endnotes **31**

Introduction and summary: Why we need a bigger public debate on financial reform

The report of the Good Banking Summit

This is a report of the Good Banking Summit, convened by nef (the new economics foundation) and Compass on Wednesday 25th of May 2011.

The summit was organised in the light of an apparent return to business-as-usual in the financial sector, in response to growing public dissent about the conduct of the banks, and to address the too-narrow remit of the Independent Commission on Banking (ICB), also known as the Vickers' Commission.

Three years on from the full outbreak of the banking crisis, a unique range of leading figures from academia, finance, politics, the law, consumer and civil society groups gathered in London, alarmed at the failure of banking reforms so far. Over 100 experts representing more than 60 organisations attended to address the question: 'what would a good banking sector look like and how do we get there?'

The context for the summit was set by government inaction, and a range of other disturbing trends and factors including:

- Stepping back from the full separation of retail and investment banking, in which retail deposits are not used in any way to underwrite the activities of higher risk investment banking, and considered by many across the political spectrum to be an essential reform to build a safe and useful financial system. The Chancellor, George Osborne accepted the interim proposal of the ICB to ring-fence retail from investment banking functions. It was the first sign of awareness from government that structural reform of the banking system is necessary. Ring-fencing, however falls short of such reform.

  Global retail banks will still be large, complex beasts, and ring-fencing will not address the 'too big to fail' problem, with its costly public underwriting. Retail banks will also still be able to make a range of high risk investments, and unless there is scrutiny of the balance of assets they are allowed to hold, they could still represent a major public liability. For example, the financial writer John Kay suggests that retail banks should be forced to hold 90 percent of their assets in the form of relatively safe business loans, residential mortgages or government bonds, which would also give positive help to the economy.

  Even under ring-fencing, capital can still be moved between the subsidiaries of investment and retail banks, as long as the capital held in each subsidiary stays above a certain level. That means again that taxpayers' guarantees will still, to some extent, be subsidising casino banking.

- The absence of proposals sufficient to change the culture of excessive remuneration, itself evidence of surplus profit generation and lack of competition

- A misunderstanding by the Commission of the implications of modern money creation which exposes the system to endemic instability, and which further leaves the public purse out-of-pocket

- The tolerance of continued risk taking for the disproportionate benefit of a few, underwritten by public guarantees

- Failure to resolve the issue of large financial institutions being 'too big to fail' and consequently presenting systemic risks. Failure to address the impact of 'too big to fail' public guarantees that generate substantial private profit for which the public finances are not compensated. The unfair competitive advantage this circumstance gives to large over small banks, which further entrenches barriers to market entry.

- Inadequate measures to ensure that businesses have access to adequate credit on appropriate terms

- No sufficient remedy to consolidation within banking since the onset of the crisis given the sector's already high degree of concentration, and the perverse nature of this outcome considering the high degree of concentration existing prior to the crisis.

- A failure of the banking system to adequately serve all areas of the UK

- A lack of consumer choice and universal service in high street banking, meaning that, as with utility companies, all citizens need a banking service and should be provided for even though some customers will be loss-making to the provider.

- No consideration of how the banking system can be rebalanced towards productive investment from its current bias toward speculative trading and blowing asset bubbles, and the consequent damage to the UK's international competitiveness

- A failure to promote concrete policies to build a more plural, diverse and resilient financial system.

In particular, the Summit noted two issues that have been barely addressed at all, including:

- the role in the crisis of the accountancy firms and credit rating agencies

- the influence of financial lobbyists on the direction of proposals for reform and the work of the ICB

The Good Banking Summit was opened with presentations by Victoria Chick, Emeritus Professor at University College London, Chuka Ummuna MP, Shadow Minister for Small Business and Enterprise, Alex Brummer, City editor of The Daily Mail, and Will Hutton of the Work Foundation. Highlights from these can be found toward the end of the report along with a full list of attendees.

Three things quickly became obvious at the Summit. First, that within its scope, the Independent Commission on Banking (ICB) was under great pressure from financial lobbyists and, second that its interim findings suggested measures that were unlikely to succeed in their stated aims of reform.

Thirdly, it was clear that the scope of the Commission was far too narrow, and therefore incapable of advocating reforms that would produce stable, safe and useful banking.

It is hard to see how any process of reform can be successful without first answering the question "what do we expect the financial system to deliver?" The question has not been properly asked, let alone answered, by the government or the Vickers Commission. The following definition is offered by **nef**:[1]

> *'To facilitate the allocation and deployment of economic resources, both spatially and temporally, to ecological sustainable activities that maximise long-term financial and social returns under conditions of uncertainty'*

Asking such questions reveals the underlying and still unchallenged free-market dogma of Vickers and the government. Social and environmental considerations are excluded, and, despite all the evidence to the contrary, the belief in the supremacy of the free-market sets artificial boundaries around what reform proposals are even admissible for consideration.

This is a reform process that not only lacks vision, but has its eyes half shut.

The Governor of the Bank of England, Mervyn King, famously commented that: "Of all the many ways of organising banking, the worst is the one we have today."

A simple summary of the Summit's findings would be that the ICB is not going far enough on key issues within its remit, like the separation of retail and investment banking, and that if the ICB cannot extend its remit to address the other areas for essential reform alluded to in King's comment, there needs to be another process to investigate the vital issues outside its scope.

The Good Banking Summit explored what would provide the foundations for a safe banking system that is also fit for purpose. It addressed areas including:

- Breaking up the banks: why and how it should be done
- Pay, risk and perverse incentives
- Optimal taxation: the quid pro quo for public underpinning of the banks
- Monetary reform and capital controls: understanding the implications of money creation for bank reform and reconciling issues of democracy and the markets
- Reform and implementation: addressing the influence of the Bank lobby
- Universal obligations and fair finance: how to meet everyone's needs
- New institutional arrangements: from a Post Bank to a Green Investment Bank, what new banking architecture is needed?
- Localisation and competition: for business and industry needs, are banks fit for purpose?
- Banking for economic transition: are banks fit to finance current major challenges like the rapid transition to a low carbon economy?
- Assessing the assessors: addressing and correcting the role of accountants and credit ratings agencies in bank failure

Setting the scene

Victoria Chick, Emeritus Professor at University College London*

Reading the Interim Report of the Independent Banking Commission (IBC), I felt I was in a topsy-turvy world. Traditional analysis of bank regulation looks first at the smaller problems – those which are earliest to appear and lead to the more serious problems – and then moves on to the more catastrophic situations. And it privileges prevention over cure. Thus liquidity is addressed before solvency, and discussions of bankruptcy and 'resolution' rarely appear. The whole idea is to construct a banking system sufficiently robust to avoid failure and resolution. By contrast, the Report emphasises the avoidance of government bail-outs and formulating rules to deal with bank failures in an orderly fashion.

Surely the first criterion of 'good banking' is that bankers take responsibility for what they do. This will require not only a split between retail and investment banking (I would favour something stronger than the 'Chinese walls' Vickers advocates) but a return to the retail banks keeping their loans on their books – an end, that is, to securitisation, at least on the part of retail banks. This will entail a massive change in banking culture and a shrinking of their balance sheets, and I have no idea how they can be persuaded to do it, but I think that unless it can be done, our banks will remain unsafe beyond the traditional structural fragility entailed in fractional reserves.

(* the full transcript of this presentation 'Banking regulation upside down' written for the Good Banking Summit can be downloaded at www.primeconomics.org.)

Alex Brummer, City editor of *The Daily Mail*

We've been through the worst crisis since just before the First World War. We've had very, very large banking collapses, but we've not looked at it at all. There's been no thoroughgoing inquiry into what went wrong in the British banking system, which is extraordinary. There's been one report which was into Northern Rock and which was produced by the internal auditors at the Financial Services Authority. It's a very good report, actually; very critical, highly critical, and basically made the case it was a dog's dinner.

In the United States, they've had two long commissions, a presidential commission, a long senate commission. There's been a Senate investigation. They've produced great, vast reports, and of course they also produced a 2,000-page act, which is incredibly complex. But we've done none of that here, and in fact we've not even seen the basic documents behind the banking crisis, the inquiry into what went wrong at the Royal Bank of Scotland, what has actually happened at HBOS, that inquiry isn't even finished, and an inquiry into Bradford and Bingley. And yet we've jumped beyond that and gone onto the Vickers commission before any of that has been done. Now, I know we wanted to be quick, and I know we wanted to get there fast, but this is a really bad process I think.

There has been a massive cover up, a refusal really to face what went wrong in the system and how to go about putting it right. Actually, if we go back through every other banking crisis, every single bank which has gone wrong in Britain in the last 30 or 40 years, there has been a commission or inquiry, and they've reported very quickly, and we got the lessons from that very, very fast. And that just hasn't happened this time at all.

I think the bankers live in a microclimate of their own and it's in that microclimate that they create this kind of need to only concentrate on the activities which make them a huge amount of money very, very quickly. That's investment banking, casino banking. That's why the consumer gets the raw end of the deal. And the madness goes on. We've done nothing to cure those remuneration problems.

We have an appalling competitive situation. We've allowed two of the biggest consumer banks to merge together, Lloyds and HBOS, and all they've done since they merged together is close branches, reduce service to customers, and sack people: 35-40,000 people have lost their jobs in that bank since it was merged. They've closed branches so customers get less service. The bit of the Vickers' report which is smallest is the competition aspect, which is bonkers because that's what a lot of us really care about: competition on the high street, the ability to get the service we need, the ability for small businesses to get loans at reasonable rates, not with having to put their mortgages up and all the rest of it to get those loans.

Will Hutton, The Work Foundation

Why I think banking went so badly wrong and is such an exhibit of bad capitalism, is because, actually, the bankers fixed the system to produce this extraordinary amount of economic rent. They ran colossal and ever growing balance sheets with ever less amounts of capital, justified by an economics that suggested free agents, with the kind of perfect information that's available in markets and in particular financial markets, can't make systematic mistakes. It was (considered) an impossibility that they could make mistakes of the type that they made.

So, in Basel II, the regulators gave up regulating complex financial institutions. They said, 'you're very clever. You don't make mistakes in financial markets because mistakes aren't made, economics tells us that. You've got enormous balance sheets so you can cover a wide spread of risk with your balance sheet. We'll basically delegate to you within this minimalist framework how much capital you want to run, and you yourselves will assess the risks waiting in your balance sheets', with the results we've seen.

Chuka Umunna MP, Shadow Minister for Small Business and Enterprise

Whenever we're looking at what we do in the banking system, there are functional short to medium term issues that we need to address. We tend to look at how you can prevent the last crisis from happening when the next crisis may be new and quite different. I have six tests for reform.

First: do the reforms protect the social utility functions of banks? We had a construct which didn't do that and meant that in October 2008, we were 48 hours away, for example, from my constituents in Streatham not being able to take money out of cash machines.

Second: do the reforms prevent banks from becoming too systemically important to fail. I think the language of 'too big to fail' is used far too loosely. If you take Northern Rock or Lehman Brothers, it wasn't the size of those banks which was the issue; it was the effect that they had in falling. They were systemically important institutions. The systemic importance means there is an implicit tax payer subsidy, which the Bank of England estimated in 2009 was worth around £100 billion. Where banks are too systemically important, we can't allow them to fail because of the domino effect.

Third: do they help promote jobs and growth?

Fourth: do the proposals better democratize the financial services sector? I have made no secrets of my desire to mutualize financial services. When mutualised, not only do the customers actually

participate in and own the institution, but institutions constructed on traditional lines are more risk averse. They take a long-term view, and have very high levels of customer satisfaction compared to the banks.

Fifthly, competition is an issue. In the personal current account market or the credit card market, there are essentially four or five big players, which in some senses is effectively a private monopoly. If we want to have better services then we need better competition.

I think the last one is, for people in the center left, the one that irritates the most, which is this need when looking at reform to consider the effects on the city's competitiveness. We might not like it, but I think to run away from that issue is a bit of a cop-out.

I don't think that there is one solution that will prevent the problems we saw in 2008 from reoccurring. I think there are a range of things we need to do. Subsidiarisation needs to be looked at very seriously. The question is not whether you do it, but what kind of subsidarization is effective. We are engaged in a kind of trench warfare between the people in the Bank of England, civil society, and the industry. The industry would rather have either an operational form of ring fencing or a geographical form of subsidiarisation, because they already have that. I think that what we need is functional subsidiarisation.

Capital and liquidity buffers are also incredibly important. Basal III should go much further, requiring something in the region of a 17% capital adequacy ratio. We must not ignore liquidity: liquidity, in many respects, is as important as capital. People bang on about capital but you can have all the capital in the world, but if there's a run on your bank, you're stuffed. I also think that we need to look into the possibility of some form of surcharge for 'systemically important financial institutions'. The resolution procedure and living wills, which the last government made a start on but didn't get entirely right, is something that we also need to move forward with. We need to look at measures that will change the culture in the City and Wall Street. That's where I think there's been a disproportional amount of attention given to remuneration, given the importance of some of the other things I've mentioned. What remuneration does do is have a massive effect on the culture of the place. I think that the Commission's biggest oversight to date has been to ignore the issue of democratisation. We have to look at how we can help banks work better for people.

Commentary: On the task of the Independent Commission on Banking (ICB)

The ICB has been presented with a near impossible task – to correct decades of City excess and weak regulation, whilst negotiating the interests of the banks, the government and the public. But the deftness of the task cannot be allowed to conceal its importance. Britain was lucky during the 2008 crash – it could have been much worse. The nation remains highly exposed to financial frailty and economic collapse because of the structural imbalance of the economy and over-reliance on the financial services industry.

Compared to other national circumstances, the British banking system remains too big to fail, too big to control and also maybe too big to save. This, combined with government underwriting of assets, creates the moral hazard of knowing that the public will pick up the bill for risk-taking that goes wrong.

The loans of the top ten UK banks are 450% of national annual output. In 1960 it was 60%. The balance sheet of US banks is only 60%. US Treasury Secretary Tim Geithner recently observed of the UK's light touch regulation, "The UK experiment in a strategy of 'light touch' regulation to attract business to London from New York and Frankfurt ended tragically". It ended in a £1.3 trillion additional public underwriting.

The ICB is looking in the right direction as far as the separation of retail and investment banking is concerned. But, from Mervyn King, to mainstream commentators like John Kay of the Financial Times, the verdict has been that the ICB has not yet gone nearly far enough. Only the banks and their closest commercial allies think otherwise following the ICB's interim report. When it was published, more than £1 billion was added to the stock valuation of the big three banks.

Any reform must be sufficient to stop another meltdown. Stopping short of this to compromise between commercial and national interests would be counterproductive. If there is another failure then the blame will be clear. As the ICB said in April, "there is inherent uncertainty about the nature of the next financial crisis." So it's not a case of if, but when sufficient reform needs to be in place.

One report can't do everything, that's why the ICB should focus on systemic risk and get that right. Over 800,000 have lost their jobs and we are now 10% poorer than before the crash, and public services are being slashed. And, all because of the banks, as Will Hutton observed:

> *"Banks ran down the capital at the core of their balance sheets, not replenishing and adding to it – but paying it out in dividends and bonuses. If they had paid out just 20 per cent less, calculates the Bank of England, between 2000 and 2007 they would have reserved more than the state paid out"* [2]

Value of banking sector to Britain

One reason politicians and regulators have failed to act is the calculation that we cannot afford as a nation to make them act in the nation's interest – that what they pay in is greater than what we pay to keep them. Figures from CRESC on the creation of social value challenge this:

i. The tax revenues from the finance sector in recent years are offset by the immediate cost of bank bail-out. In five years up to 2006/7, the finance sector paid and collected £203 billion in taxes, but the upfront costs of the UK bail-out are £289 billion, rising potentially to £1,183 billion.

ii. In terms of job creation, the finance sector directly employs no more than 1 million workers (mainly in retail) and numbers employed do not increase in the boom years. If we add jobs in consultancy, accounting and law sustained by finance, the number of those directly and indirectly employed by finance still accounts for no more than 6.5% of the UK workforce.

iii. The business model of wholesale banking and the geographical clustering of wholesale activity, together ensure that the finance sector concentrates rather than diffuses employment opportunities and prosperity across the UK. Retail banks control the costs of high street jobs, while wholesale pulls a small number of well-paid financial actors towards its centre.

In its present form, finance is a pro-cyclical activity with limited job creating capacity and a proven ability to disrupt the economy at great cost to the taxpayer.

The banking activities that created the problem deliver little social value, they operated for themselves. Under pressure for shareholder value, banks overcame the handicap of high fixed costs, intensifying competition and low spreads. They did so from the 1990s onwards by pushing into new activities like proprietary trading in wholesale and mass marketing in retail. They created a new sectoral business model that fused retail and wholesale through securitization and turned banking into a giant 'transaction generating machine'.

This 'transaction machine' created huge amounts of unsustainable shareholder value in the bubble years when finance and insurance accounted for more than 30% of all FTSE 100 profits and British banks sustained Return on Equity of 15–25%. Corporate governance was an ineffectual brake on risk-taking which was actively encouraged by a dysfunctional joint venture between wholesale 'talent' and shareholders. The 'comp ratio' was an explicit understanding that the wholesale workforce was entitled to around 45% of net turnover.

Will they leave?

The second fear of the politicians and the regulators is that if pushed by reform the banks will leave the UK. The above arguments raise the question about whether this matters, but there is, either way, no objective case for them to leave. The average annual subsidy because of cheap borrowing based on government underwriting was £50bn for the top five (2007-9) according to Andrew Haldane of the Bank of England. Most countries cannot and do not offer this level of support.

Barclay's Bob Diamond told the Treasury Select Committee on 11th January 2011 that even if his bank was broken up, it wouldn't quit the UK. Whereas, a press cuttings search on HSBC will show they make noises about leaving the UK every year. UBS, on the other hand, have said they might move to London because of tough capital requirements in Zurich. Once these two ungrounded fears are dismissed, then the ICB can examine reform from the basis of what works.

The ICB needs to confront why regulatory reform alone – that is, the tweaking of checks and balances – is unlikely to work, and why structural separation is needed, and the right path to take.

Regulatory and Structural Reform

An asymmetry of information between regulator and the regulated means that, from the outset, the regulator is at a disadvantage, and playing a game of 'catch-up'. The insiders always have more knowledge than the outsider. The interim report even talks about being, "mindful of regulatory arbitrage possibilities at the boundary".

Regulation alone may just be a boon to lawyers. The incentive of rewards, and therefore risk, will be maintained as Chinese Walls collapse under competitive pressure, to come up with new products and services that will, sooner or later, once again become reckless.

Decontamination by firewall is impossible to execute. There won't be ring fences, but open borders, as no CEO will be prepared to let one side of a business fail when it could be saved from another part. If there is a run on a bank, without full separation what depositor isn't going to queue up just like they did at Northern Rock and cause a run? The cost of trying to ring fence will be huge as banks try to separate IT, HR and all banking processes. Who will be the border control guards? It is potentially a regulatory, legal and accounting minefield.

It would be much better for them to avoid such costs by taking the structural option, through full separation. Indeed this was the route taken by previous UK regulators when they knew, as in the case of energy, that they could not regulate for effective internal separation. Instead the creation of power was separated from the delivery of power. In banking the idea of such structural separation is much easier, as investment and retail function are different products and services. There may be some blurring at the edges, but the two markets are separate and should be treated as such. As Vince Cable said in May 2011, "Casinos belong in Las Vegas not in banking."

Reports of the working groups

The purpose of this section is not necessarily to produce a definitive manifesto for further bank reform. Its purpose rather is to demonstrate how many severe, ongoing failings of the financial system lie outside any formal process of review, such as was referred to by Alex Brummer. In that light it is an invitation to the ICB to recognize the implications of their own, strictly limited remit, and to explore what further procedures, such as a Royal Commission on Banking, might be necessary, and to call publicly for such steps to be taken. That said, these sections contain many short to medium and long term proposals which would make the banking system safer and more fit for purpose.

The separation of casino-style investment banking and retail banking: why and how it should be done

There are a variety of arguments for why the largest UK banks should be broken up. The departure point for analysis is a proper understanding of banks' business models – how exactly they seek to generate profits.

Retail banking has increasingly become a marketing-led and fee-based, product sales business. The proportion of income derived from the traditional interest rate spread has declined to be replaced by fee income and sales of financial products which are heavily marketed and sold, sometime mis-sold as the PPI affair has demonstrated, through branch networks.

Meanwhile, as investment banking has become consolidated into larger global institutions that both advise clients and trade on their own account, they have become more able to exploit their market power, both in terms of positions in particular products or markets, but more generally in terms of information asymmetries between them and their clients, to generate higher returns.

The many sources of market failure require broader remedies than either separation along Dodd-Frank / Glass-Steagal lines, or branch sales to create large new entrants to the high street. Among others, remedies are required to improve transparency, and tackle perverse incentives in funding and ownership structures and remuneration. For example, instead of being awarded for achieving sales growth, bonuses should reward customer service or even long-term value creation.

That said, effective separation is a vitally important objective. Opponents of splitting up the banks argue that it was often the retail banking arms that got into trouble, not the 'casino' investment banking arms. While there is much truth in this, it actually bolsters the case for a clear division. Retail banks should not be putting risky assets such as CDOs and derivatives on their balance sheets at all. They should not be securitising all their loans. They are there to promote real prosperity by lending to businesses and people, and making sure that they lend responsibly. Only a clear division provides the necessary transparency between the very different functions and cultures of investment and retail banks.

That is not to say that a retail bank might not in future make lots of unwise property loans and get into trouble, but no one claimed that a new Glass-Steagal Act would solve all the dysfunctional aspects of the banking system.

The case for breaking up banks

There is an oligopoly in banking, meaning no effective competition. Excess returns, exemplified by 'bonus culture' are common and at the root of many other problems. The allocation of credit by banks has not been 'socially and economically useful', as Adair Turner, head of the FSA, put it.

The government has perpetuated the problem by saving failed institutions without any reform, and in fact worsened it by allowing further concentration between HBOS and Lloyds. Arguments about competition must take account of the distinctive nature of banking, in requiring state backing to maintain confidence in the monetary system and to prevent broad economic and social damage from banking failures.

Mixing utility and casino banking does not work for a number of reasons: there are different risk and reward profiles; different governance and ownership structures are appropriate; they produce different cultures of work; the ability to cross-sell in the bancassurance model is a further opportunity for mis-selling.

Separation though, is insufficient by itself as many other problems exist ranging from conflicts of interest between different parts of investment banks themselves, through to how the whole speculative sector has become too large, leading to the overfinancialisation of the UK economy, massive distortion of resources and overexposure of the economy to bank balance sheets.

The ICB process has failed to ask the questions about bank's business models and how they actually make money. Understanding this is relevant to the question of whether or not, and how to break them up. The problems include lack of competition, mixing utility and investment banking, and that financialisation has led to the whole sector being oversized, relative to the economy. To solve those problems, the working group on separation recommended:

- A complete split between retail investment banking, and within that a consideration of splitting investment banking into its advisory and underwriting functions and its proprietary trading functions. Further, that the ICB should examine splitting trading services between those done at the client's risk and those done at the bank's. In many areas these are blurred and afflicted by conflicts of interest. It is no surprise that banks with a broker-dealer business model (eg, Goldman Sachs) make more money from trading than any other area of banking. One of the benefits of separating these out would be to provide different regulatory regimes for each, i.e. those activities which take on more risk need more capital.

- Rethinking incentives structures for executives, and possibly incentivising through the cost of funding which might lead to banks concluding that they are, in any case, better off to break themselves up. For example, there has been some speculation that were SIFIs (Systemically Important Financial Institutions) to be required to hold extra capital to reflect the heightened risk they pose to the rest of the economy, they might conclude that they were better off breaking themselves up to the point that they were no longer systemically important. Such approaches use the power of market mechanisms to act in the public interest to regulate the behavior of banks and bankers; in the language of economist they 'internalise the externalities'. As the FT observed, SIFI status should not be allowed to become a badge of honour. It will only help big banks become bigger as 'too big to fail' banks get cheap capital. A SIFI surcharge, however designed, therefore needs to be punitively high.

- Asking customers what type of banks they actually want. For example, poll them to ask, 'do you want your retail bank to also be an investment bank? Are you happy that the bank uses your deposits in risk-prone speculation?' Depending on feedback, the government could look into a Big Society people's bank to be rescued out of Lloyds and to retrieve Halifax, to be restored as a safer, more user-friendly mutual financial institution. It would be a retail bank for the people.

Pay, risk and perverse incentives: getting the signals right

The ICB report includes just one paragraph on remuneration which makes no recommendations, but repeats the provisions of the Financial Services Authority revised 2011 Remuneration Code that requires remuneration policies and practices to be consistent with, and promote effective risk management. The reforms put in place by the FSA, which include dividing rewards between cash and shares, may shift incentives slightly towards the longer term, but they fail to ask more fundamental questions about risk and incentives. Rather than, how do we blunt the edges of a bad system, the real question is: 'Why do we pay bonuses at all? What is their legitimacy?'

The banks argue that there should be no public interference in what is essentially, a private matter. Yet, as most clearly manifested in the 'too big too fail subsidy' the banks are dependent on public support for their survival. In short, the position that the banks occupy in the economy means that their business is our business.

There is a significant body of evidence to show that excessive rewards lead to bad decision making. **nef**'s report *The Ratio* (June 2011) summarises research into the way that high pay as an incentive not only fails to produce better performance at work, but can be actively damaging. For example the consistent outcome observed in findings from 128 experiments cited by Daniel Pink[3] was that, 'tangible rewards tend to have a substantially negative effect on intrinsic motivation'. The psychologist Alfie Kohn wrote that: 'Not a single controlled study has ever found that the use of rewards produces a long-term improvement in the quality of work. Rewards usually improve performance only at extremely simple – indeed, mindless – tasks, and even then they improve only quantitative performance.'[4]

We find nothing in the FSA's Code that remedies this, and are concerned that the ICB's failure to address remuneration leaves the banking and finance system vulnerable to excessive risk taking. There are major flaws in the arguments used to justify bonuses that need to be aired. Other industries function perfectly well without bonuses, why not banks? There are also precedents within the banking system. The Swedish Bank Handelsbanken pays no bonuses and is one of the best performing. Customers of major Dutch Bank ING mobilised on social networks to protest at bonuses paid to bosses at the bank. Within days the bank's chief executive agreed to waive his bonus and told other ING directors to do the same.

We find little evidence that the banks have proven themselves able to show moral restraint in the excessive awards they have given themselves. Given that, with the best will in the world, the likelihood is that a small group of individuals are likely to implement policy and rewards that preference them, and those like them, we find strong evidence of the need for both total transparency on remuneration and broader representation on remuneration committees.

The recent report of the High Pay Commission puts excessive levels of remuneration into perspective with banks out in front.[5] The financial sector accounts for one third of the 0.1 percent at the very top of the pay scale. Unless remuneration habits change, by 2020 their pay will have reached a level 214 times greater than the average. The Ratio points out that while take home pay fell during 2010 in the UK for the first time in 30 years, boardroom pay rose by an estimated 55 percent in the FTSE 100 and 45 percent in the larger FTSE 350.

The ICB should address the source of super profits, of which bonuses are a symptom. That means looking at each area of banking in turn and identifying the source of super-profits in each. These might range from high overall leverage, to risk weight manipulation, oligopoly in underwriting, public subsidy in lending and structured credit, thought to informational asymmetries in trading. This will attack bonuses at their source.

The experience at Lehman suggests that paying large bonuses in the form of long-term equity allocations instead would not have helped. If bonus rules are to be reformed with caps, the ICB could also consider a clawback linked to an individual's direct areas of responsibility, or to paying bank bonuses in new equity with double liability, so bonuses are no longer one way bets.

The UK government has expressed outrage at 'excessive' pay in the public sector and pushed for restraint. Yet the Government seems unwilling to tackle excessive pay in the finance sector where both the orders of magnitude and the ratios are far greater. What is good for the public, it follows, must also be good for the private.

In order to remedy this, and to create a more coherent and stable system we recommend that:

- Pay must be fair, and must be spread more evenly throughout the banks. This will help the banks to function more effectively as a whole, and will reduce incentives to take excessive risks
- There should be an immediate global 'bonus cap' pending further investigation of the practice. This should also take on board the interim recommendations of the High Pay Commission
- Any incentives that are paid should be tied to customer service not sales, and this related to long-term relationships, not short-term risk taking, if it is to lead to a culture change within the banks. Bonuses should be based on collective endeavour and distributed evenly though the institution as they are in the John Lewis partnership
- Bank profits should be more evenly distributed between remuneration, shareholders, tax and customer service
- Remuneration Committees should have broader representation. This should include front-line staff from the retail banks, and bank stakeholders including small business representatives, retail bank customers and shareholders
- New players in the sector would create more competition that could play a significant role in changing bank culture. Lloyds branches could be divested to other players that don't pay bonuses – such as the Handelsbank Bank, or Mutuals.

Optimal taxation: the quid pro quo for public underpinning of the banks

In light of the failure of the various enquiries into individual bank failures and the limitations of the remit given to the Independent Banking Commission, a Royal Commission with a wide-ranging brief should be instituted to enquire into the working of the financial markets. Its brief should include the perverse incentives and distortions which our tax system creates. This would include, for example, assessment of the special treatment of hedge funds and private equity companies; the different tax rates charged on capital gains compared to income; the distortive effect of tax deductibility of interest payments on loan capital (compared to tax treatment of equity capital).

The Commission should be briefed to recommend how to create a fairer and more stable tax system, including consideration of:

- introduction of a Financial Transactions Tax whose rate should not be pitched so low on the grounds of needing to make it broadly acceptable, as to have little or no effect on the churn in the markets, which is one of the prime causes of instability.
- a unitary system of taxation for multinational banks, whereby they are taxed on global profits allocated between the different states where they were generated, on formulary basis taking account of genuine economic factors rather than legal fictions.
- abolition of the special treatment of persons resident in the UK but claiming to be not domiciled in the UK for tax purposes.

- introduction of a Land Value Tax to capture economic rents and mitigate against boom-bust cycles.

In view of the failure of multi-lateral efforts to tackle secrecy jurisdictions, the Commission should also be briefed to consider the general issue of how secrecy jurisdictions operate and how to bring the international race to the bottom on tax and regulation to an end.

Monetary Reform and Capital controls: how understanding money creation shapes bank reform and reconciling democracy and the markets

We have become dependent on the banking sector to provide the money supply for the nation. That means that an essential economic utility that should function for public benefit, is operated by private hands and motivated by the maximisation and capture of profits privately. Money is put in to the economy as debt. We should take away the virtual monopoly enjoyed by the banks over the creation of money, so that its benefits can be captured for public benefit by other actors including the state. Banks could then have their original function, more as intermediaries restored.

The ICB appears to have misunderstood this fundamental issue about how modern banks actually operate. On page 16 of their report there is definition of lending which states the following:

> *However, banks do not take deposits simply to provide safety for the savings of the public. They use funds that are deposited with them to provide loans to businesses to allow them to undertake productive economic activities, and also to consumers…*

But this is just a remarkably resilient fiction, and has been since the birth of modern banking in the UK in the second half of the seventeenth century.

When a bank makes a loan it does not take other people's deposits and lend them out. This would imply that no new bank deposits are created in the economy when a bank makes a loan. When a bank makes a 'loan' it simply types in to its account that the borrower owes it a sum of money – this is the bank's asset. It also types into the customer's account that he has a bank deposit of the same amount – this is the bank's liability. No other customers' deposits are altered in any way.

The borrower then spends that loan somewhere else. The bank has thus created new purchasing power without removing purchasing power from anyone else. After the loan has been spent, it ends up in another (or even the same) bank as a deposit. An electronic demand deposit in a bank is money. It will be accepted by everyone in the UK economy because it carries the same status as sterling paper notes and is accepted to pay tax. Deregulation and advances in technology (in particular debit and credit cards) mean that 97% of the money in the UK is this 'bank-money'; only 3% is created by the central bank as paper notes.

The implications of this fact are enormous. Banks create nearly all of the new 'money' in our economy through their loan activity. They play an absolutely central macroeconomic role. The tens of thousands of loan officers making decisions everyday about who should receive loans are shaping the outcomes of the economy. The Bank of England is barely able to affect the amount of credit, or money, that the banks create and no authority has any say over how banks allocate this new credit.

The ICB's suggestion that banks allocate money to 'productive economic activities', has no basis in empirical reality. The last two decades of actual banking activity in the UK tells us that banks tend to prefer creating credit for either short term speculative returns (financial market trading) or longer term non-productive credit creation (mortgages and commercial property).

The result has been a massive asset bubble in housing and the 'financialisation' of the UK economy as more and more profits are made through financial speculation as a proportion of GDP. The ICB's report (page 22) shows the UK as having the largest banking sector relative to its economy out of 19 leading industrial countries. Unless the ICB, the Bank of England and the Treasury start to take more seriously the true role of banks as the creators of the overwhelming majority of new purchasing power in the economy, effective reform will be impossible. Focus instead will remain on propping up a banking model that specialises in speculative credit creation and has become so big that it is underwritten by the taxpayer.

'Full reserve banking,' elaborated in nef's submission to the ICB, would be one way of achieving this. So far, however, the ICB appears not to have understood this proposal, stating that it would 'drastically curtail the lending capacity of the UK banking system, reducing the amount of credit available to households and businesses and destroying intermediation synergies.' (page 98).

It's unclear on what basis the ICB has come to this conclusion. Full reserve banking would not would stop people putting their savings in an 'investment account' which would then be lent out at interest by banks in just the way the ICB describes in its report (above). But if people wanted to keep their money 100% safe, they could also do this by putting it in a custodial account that could not be lent in to the economy. The need for deposit insurance would then be completely removed and the taxpayer would never again have to bail out the banks and see the enormous cuts to public services that have been the result. This does not argue for a'shrinkage' in total credit in the economy – the total money supply could remain at the same amount as it is today.

We suggest that instead of private banks making the key macroeconomic decisions about the quantity of credit in the economy, this decision could be taken by an independent group of policy makers, in much the same way as the MPC decides upon changes to interest rates. This is, perhaps, a role that the new Financial Policy Committee could take on, which was set up to take a 'macro-prudential' (i.e. broad) overview of the economy as part of the Bank of England.

The creation of credit (money) would be separated from its allocation, instead of the current system where both are combined in the hands of undemocratic private banks. Credit would be allocated by different tiers of government subject to democratic accountability, for larger infrastructure projects and, for less strategic investments, banks would play the intermediary role of recycling savings. In this way we might move towards an economy where credit is channelled away from 'socially useless' activity and towards productive, job creating areas, whether that be building a low carbon energy and transport future to simply ensuring small businesses get the working capital they need to survive, innovate and create jobs.

Regulating interest rates

Whilst full-reserve banking proposes to limit the quantity of credit at a macro-level, another approach would be to regulate the price (interest rate) of credit. Currently the UK has one of the most liberalized credit markets in Europe, with interest rate caps gradually removed over the course of the 1970s, 80s and 1990s by successive governments in the name of free markets. Rather than allowing banks to charge whatever they wish, banks could be forced to lend at much lower levels (e.g. 2%) to small businesses and other key productive sectors – housing, transport, green energy infrastructure – that are currently starved of credit. Such an approach was used by Keynes to ensure Britain was able to fight the World Wars and has been proposed in the Green New Deal reports.

There are huge challenges facing both of the above proposals, no least the globalization of capital flows which may limit the extent to which individual states are able to impose stricter regulations on the quantity, price and allocation of credit (see below for more). But there are many historical examples of more regulated systems proving effective in terms of productive growth, not least South Korea and China as well as in Britain during War periods.

At the very least, the misunderstanding at the heart of policy making concerning the creation of money remains a glaring anomaly, urgently in need of re-assessment, and without which other reforms are unlikely to succeed.

Capital controls as necessary ingredient for reform – regulating destructive flows of capital across borders[6]

> *"Experience shows that when policies falter in managing capital flows, there is no limit to the damage that international finance can inflict on an economy."*
>
> Yilmaz Akyüz

Today the Tobin Tax, or Robin Hood Tax is a high-profile issue, with some signs that EU governments are considering implementation of such a tax. Control over capital flows (now re-designated as 'capital flows management' by the IMF), once taboo is now actively discussed, even though debate is limited to controls on inward flows. Debate on controls over outward flows – illicit capital flight that makes it so easy for corporations and elites to export their gains – is still taboo. The big change came in February, 2010, when to the surprise of many, IMF staff accepted that 'capital controls are part of the policy mix'. And by April, 2011, the Fund had developed a 'framework' to help countries manage capital flows.

As Prof. Chick has noted, there is no economic debate about what agency is ultimately responsible for the money supply and what underpins it. Classically, this is the government's responsibility; they have abdicated partly under the pressures from the globalisation of banking. Yilmaz Akyüz, chief economist at the South Centre, Geneva and former director of the Division on Globalization and Development Strategies at UNCTAD argues that unstable capital flows and commodity price booms show that 'the international monetary and financial system needs urgent reforms'. He quotes Ben Bernanke's speech to the Banque de France in February, 2011:

"Looking back on the crisis, the US, like some emerging-market nations during the 1990s, has learned that the interaction of strong capital inflows and weaknesses in the domestic financial system can produce unintended and devastating results. The appropriate response is…to improve private sector financial practices and strengthen financial regulation, including macroprudential oversight. The ultimate objective should be to be able to manage even very large flows of domestic and international financial capital in ways that are both productive and conducive to financial stability."

Akyüz concludes that 'macroprudential regulations, as usually defined, would not be sufficient to contain the fragilities that capital flows can create'. Instead, controls over both inflows and outflows should be part of the arsenal of public policy, used as and when necessary and in areas and doses needed, rather than introduced as ad hoc, temporary measures.

And we do not have to re-invent the wheel. 'The instruments are well known and many of them were widely used in the advanced economies during the 1960s and 1970s.' While politicians, economists and regulators may be more alert than they were in advance of the 2007–9 slump, they remain submissive to a global banking lobby and passive at the wheel of the global economy. This leaves commodity speculators unfettered by regulation and free to steer the global economy towards another financial precipice. Only this time central bankers and governments will have fewer tools and resources (i.e. taxpayer largesse) available with which to rescue bankers and speculators from their reckless and worthless endeavours. Nevertheless, soon after the next crisis – which will again cause massive economic failure and dislocation, intense human suffering and pain – controls on capital flows will finally be applied. How much better it would be to act and use them in advance.

Assessing the assessors: the role of accountants and credit ratings agencies in bank failure and what should be done

> *"Ratings assigned to structured financial instruments proved to be inaccurate, often by a wide margin, raising concerns about the effectiveness of CRAs' financial models and the management of conflicts of interest inherent in the 'issuer pays' business model."*
>
> ICB, p176

The ICB recognises the complicity of a range of the institutions that are designed to provide the checks and balances in the system in the failure of the banks, the Credit Ratings Agencies that continued to provide gilt-edged AAA credit ratings in the knowledge that the products they were rating were inherently risky, and the accountancy firms that signed off the banks accounts who could, and should have spotted the signs of danger.

Three privately owned firms, Fitch, Standard & Poor's and Moody's, continue to enjoy immense, global power – power over the lives of millions of people – but have minimal accountability. CRAs assess the risk of default of debt products traded in the financial markets. In doing so, they strongly determine the interest rates governments and companies have to pay to service their debt. CRA ratings are bound into our legal framework. Institutional investors, such as pension funds, are only permitted to invest in securities rated above a given level. In the US, the Financial Crisis Inquiry Commission that reported in January 2011 found that:

> *"The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies."*

The accountancy firms knew that banks were severely over-leveraged, indulged in tax avoidance at home and abroad, kept assets and liabilities off the balance sheets and gambled deposits on the movement of exchange rates, interests rates and commodity prices. Yet none challenged the banking industry. When challenged by the Treasury Select Committee in November 2010, John Connolly, the head of one of the UK's biggest Accountancy firms admitted that they had given the banks a clean bill of health because they were a 'going concern', because the assumption was made that if they failed, they would have been bailed out by the taxpayer.[7] At this point, Lord Forsyth of Drumlean, commented:

> *Are you saying that, looking at the position, you thought that the bank was likely to be in trouble but you couldn't possibly say that because that might precipitate the crisis and, therefore, by giving assurance you took the view that the accounts were okay?*

All distressed banks received unqualified audit reports even though some US banks were being closed and Northern Rock was being rescued by the UK government.[8] There is the recurring problem of auditor independence, fee dependency on banks and the cosy relationship with directors, leading to silence and the absence of any red flags from auditors. Seemingly, no lessons have been learnt from the mid-1970s banking crash, Johnson Matthey, BCCI, Barings, Northern Rock, Lehman Brothers and other episodes.

There are additional problems. The financial sector and big auditing firms have too much influence on accounting rulemaking, as evidenced by the 'fair value' controversy. Too many vital issues are organised off the agenda. The International Accounting Standards Board (IASB) is a private limited company based in London owned by a secretive Foundation in Delaware. It is funded by the Big Four accounting firms and big banks and has no independence from them. For the financial regulators to make sound judgments about capital adequacy, solvency, liquidity and risks, it is vital that the accounting and disclosure rules be made by a body independent of corporate interests, acting in the public interest.

Regulation of the Credit Rating Agencies falls beyond the remit of the Commission and other processes are in train that are designed to address these areas. Nevertheless, a secure and stable financial system will not be possible without reform, not only of the banks, but the range of institutions that service the banks. There are clear conflicts of interest between the Credit Ratings Agencies, the accountancy firms and their clients in the financial sector that must be resolved if we are to build a stable financial sector that is fit for purpose. The recurring problem is that, in common with most business regulation, the regulation of banking has been handed over to the banking industry, which it has a powerful interest in protecting.

As the ICB recognises, EU Regulation on CRAs and the Dodd-Frank Act have both introduced a number of reform measures including granting regulators supervisory powers over CRAs, imposing activity restrictions and enhancing transparency requirements. In the EU, regulatory integrity is addressed by a requirement for effective systems and controls around financial models. In the US it is addressed by the empowerment of the Security and Exchange Commission to fine or revoke licences of poorly performing CRAs. Both pieces of legislation are a welcome step forward fundamental conflicts of interest that are left unchecked and must be resolved if we are to rebuild a stable system from the ashes of the old.

There are fundamental conflicts of interests between credit rating agencies and accountants, and their clients in the financial sector. In that context, highlighted areas for reform include:

- We need a public body to rate products as a condition of a banking license – this would be in addition to the free market ratings agencies who banks could still use as well if they want

- Full disclosure of all ratings agencies information and methods

- A public regulator to assess and report on this data and information

- Credit ratings to be revised periodically and not be once and forever evaluations

- There should be licensing of financial products that are stressed tested and given a kite mark like food

Then, in terms of accountancy in relation to the banks:

- Banks should be audited on a real-time basis directly by the financial regulator or a public body specifically created for that purpose. This would enhance independence, build in-house expertise and also reduce reliance on others.

- Accounting standards should be formulated by an independent public body, with all its proceedings in the open and all its documents on the public record.

- Banks that violate accounting and disclosure rules should risk losing their deposit-taking licence.

- Audit files should be publicly available for scrutiny by stakeholders.

- Effectiveness of accounting and auditing practices should be reviewed biannually by the House of Common Treasury Select Committee.

Transparency and democracy: how to address the power of the bank lobby

The power of the financial lobby is without parallel. In the US, banks spent a total of $5bn between 1998 and 2008 donating to parties and investing in lobbyists to secure a favourable legislative and regulatory environment. A report from the organisation Wall Street Watch details a dozen specific deregulatory steps that helped create the conditions that led to the financial crash.[9]

Research by the Bureau of Investigative Journalism published in February 2011 noted that:

> *"Last year City money made up 50.8% of all Conservative Party donations, a leap from 25% five years previously, when Cameron and Osborne took over the helm. The City has donated a total of £42.76m since 2005. Last year City money accounted for £11.4m, compared with £2.75m when Cameron took over."* [10]

Apart from wider issues of concern about the disproportionate influence of the City, it is also vital to understand the link between lobbying and the financial crash. A 2009 report from the IMF[11] tellingly showed:

> *"(US) mortgage lenders lobbying more on issues related to mortgage lending (i) had higher loan-to-income ratios, (ii) securitized more intensively, and (iii) had faster growing portfolios. Ex-post, delinquency rates are higher in areas where lobbyists' lending grew faster and they experienced negative abnormal stock returns during key crisis events."*

In the UK, we have no idea how much money the financial services industry invests in lobbying, nor the scale and sophistication of its activities. Current transparency measures do not enable public scrutiny of lobbying: the industry-operated voluntary register of lobbyists, lacking both depth and breadth, is widely seen as not fit for purpose; official registers, whether of outside interests, ministerial meetings or party donations, offer scant or tangential details of lobbying that are neither satisfactory nor complete.

It is therefore welcome that the coalition government has committed to introducing a statutory register of lobbyists. However, the slow progress of the policy – and the lobbying industry's efforts to pre-empt and weaken the regulations – is a cause for real concern. A statutory register of lobbyists appears to be very much on the legislative back burner.

A robust Statutory Register of Lobbyists must include:

- The name of the individual lobbyist; and the special interest they are lobbying on behalf of (either the employer if it is in-house, or agency clients)
- Information on any public office held by the lobbyist within 5 years. This would reveal the revolving door between industry and officialdom
- The public official or body being lobbied; and the area of policy they seek to influence
- The amount of money spent on lobbying (a good faith estimate). This will reveal scale, disparities and trends in lobbying

The Independent Commission on Banking should in its subsequent publication explicitly recognise the power of the bank lobby and its influence in shaping policy. Until it does, wider stakeholders will view conclusions from the IBC with scepticism.

Now more than ever, at a time when the financial services sector is going through an era-defining phase, a Statutory Register of Lobbying is needed.

The Prime Minister when in opposition last year stated that lobbying was "the next scandal waiting to happen… We don't know who is meeting whom. We don't know whether any favours are being exchanged. We don't know which outside interests are wielding unhealthy influence… I believe that it is increasingly clear that lobbying in this country is getting out of control."[12,13] Such a register represents a baseline position.

The Good Banking Summit notes how in Brussels legislation recently passed by the European Parliament to ban naked short selling of sovereign debt in Europe – a measure aiming to restore a semblance of stability to European economies –has ignited a huge lobbying drive from the International Swaps and Derivatives Association to overturn the measure.

In Brussels, Finance Watch, a newly created organization designed to be a counterweight to the bank lobby, estimates there are 700 lobbyists dedicated to the financial services alone. Finance Watch estimates the amount spent on financial lobbying in Brussels to be over €300m.

Wider society does not have the firepower to match this onslaught. There needs to be mechanisms put in place to redress the balance. The Good Banking Commission urges the IBC to address this issue.

To help achieve this, a Good Bank Network or Banking on Change portal needs to be established to give the public the tools to engage with the banking sector which has repeatedly failed it through among other things:

- repeated mis-selling scandals
- high charges
- bad customer service
- "pump and dump" internet stock scandals
- the leverage scandal

Easily understood information, widely disseminated and designed to cut through the arguments perpetrated by the bank lobby needs to be made available immediately to give a balanced picture and level the playing field.

Universal Obligations and fair finance: meeting everyone's needs

Money has become a fundamental building block of society – it is not simply a good or a service, but the universally recognised mechanism of exchange which all have to have access to in order to operate and survive. Banks create and control the flow of money; as a result they have significant power over the ability of each individual to trade for both necessities and luxuries. In that context, to deny people access to the tools which are used to manage the universal unit of exchange is to prevent people from participating in society. Hence banks are not the same as other commercial entities. And yet many people are denied or lack access to even basic banking facilities.

Current risk assessment models contribute to the imbalance in the banking sector. The risk posed by individuals managing their daily finances is considered within the same financial framework as the risk posed by financial instruments at the corporate investment level. It is crucial to separate out these in order to ensure that the individual is not damaged by corporate investment interests.

Current access to financial services and products is highly unequal. Different groups of individuals, determined by income, literacy, numeracy, confidence, ethnic background, and internet access have differing access to: transactional accounts; credit; insurance and other products.

Main types of Financial Needs – equally valid for Joe Public and Vulnerable Groups

Safe place to keep money e.g. current account	Mechanism to receive income e.g. current account	Mechanism to purchase goods and services at best price e.g. current account, credit card, on-line payment methods	Tool and place to build assets e.g. savings account	Tool to access credit e.g. overdraft, loan, credit card	Tools and services to protect aspects of life e.g. insurance, pensions

The quality of customer service is also highly distorted depending on background and income. Excessively profit-driven financial services often result in customers with lower earning potential receiving inferior service in bank branches or on the telephone.

Because the majority of financial products and services are designed to make a profit, it means that they are not designed with the vulnerable or excluded in mind. For these reasons, reforms are needed including:

1. A social contract: any license issued to a financial services provider must include a social contract element, managed and regulated by the new financial services regulator.

2. Individual and corporate risk assessments and ratings must be separated into different processes and calculations.

3. The current model of ownership of financial institutions contributes to the problems highlighted here due to a lack of diversity in ownership types. We need to investigate and support alternative models of ownership which encourage more equitable practice, e.g. mutuals and cooperatives.

4. We need to revisit usury laws to support and encourage responsible and equitable providers of credit. For example, why is it that credit unions are restricted on APR but no one else? But the basic question, of what it costs to live in society, must also be asked. If people are living on such low income that they have to rely on credit to live, there is a broader political and economic failure to do with basic levels of poverty to correct.

Institutions: from a Post Bank to a Green Investment Bank, what new banking architecture is needed?

Practical examples of more diverse forms of banks should be highlighted and examined for how they can improve the financial sector in the UK. From Germany to Japan, and New Zealand, and the United States to Switzerland, many other forms are available. Diversity is a key characteristic of resilience.

In the UK, we have the Big Society Bank, the Green Investment Bank and Triodos which favours depository receipt holders in favour of traditional shareholders who in turn become its equivalent of shareholders. Although small in comparison to dominant financial service providers, these organizations demonstrate that a more plural system is beginning to emerge.

The Big Society Bank, in particular, could leverage the funding of other, alternative models by funding innovation and encouraging the growth of social enterprises. The British Banking Association has set up a Business Growth Fund for equity investment in small enterprises and this was considered a positive step.

Case Study: The problems that a Post Bank could solve

'To date responses to the crisis have tended to focus on rebuilding the capital of the banks, to make them more secure. Yet what struck us is not just the problem of bank solvency. Rather it was the degree to which the financial crisis highlighted systemic problems in a sector that had, for a long time before the crisis, failed to deliver for its customers or for society at large. Putting more capital into the banks, and then returning to 'business as usual' is not enough. We need to build a sustainable banking sector, focused on delivering value to the economy outside its own financial world.'

Future of Banking Commission Report, June 2010

The Post Bank coalition believes that the case for a publicly owned Post Bank has been strengthened by the banking crisis and the systemic failure of the industry. Beyond this, it is clear that the sector is failing to cater to communities and businesses across the country.

Despite pledges from banks to increase lending to small businesses, the total amount being lent was 2% down on 2010 in the first quarter of 2011 and in the two months to March the FSB reported that around 40% of small businesses applying for credit were turned down by their bank. Alongside this the cost of credit is rising significantly on both new and existing credit facilities: almost a third of businesses with loans or overdraft facilities, and almost 40% of those applying for new finance, have seen increases of more than 2% on the cost of credit compared with a year ago, despite the Bank of England rate remaining at a historic low. This trend is in marked contrast to larger businesses, for whom the cost of credit is remaining stationery or improving.

We do not suggest that the creation of a Post Bank is the solution to the ongoing banking crisis. But we do say that a trusted, narrow retail bank with a network of local branches would add diversity to the current system and would be popular with the British people. We need a bank which will concentrate on servicing the community rather than selling financial products to customers who don't need them.

(This has also been demonstrated through the mis-selling of payment protection insurance (PPI) – with billions of pounds in compensation set to be paid – at the same time as while banks paid out significant bonuses and engaged in tax avoidance).

A large part of the problem has been the retreat by high street banks from local communities. Physical premises are important, particularly to small businesses which make heavy use of branches, but the UK has fewer than half the number of bank branches per head of population than France, Italy, Germany or Spain, and of the 2,800 communities in the UK which do have a bank branch, more than 1,000 of these – around 37% – are catered for by only one bank.

Lack of competition is a particular problem for SME banking, with five banks holding over 90% of the market, and in both small business and personal banking competition has reduced since the financial crisis. Throughout 2010 the average amount of new lending to small businesses was 46% lower than 2008 and overdraft lending has dropped by almost a fifth.

The banking system has failed, with disastrous consequences for our economy, mainly:

- the cost of bailing out insolvent UK banks
- the loss of productive capacity in the UK economy arising from the economic crisis

- the impact on the public finances through that loss of productivity capacity – leading to lower tax receipts
- the reduction in UK output by almost 9 percent per year.

A Post Bank would:

- Provide a popular, locally based bank, interested in the small retail and business customer
- Develop new ways of providing retail banking goods and services
- Strengthen local economies
- Underpin the future survival of a strong Post Office network
- Demonstrate that banking is a social and economic utility

A Post Bank would be a local service provided nationally. Arguments against Post Bank cite capital costs of set up, capitalisation, lack of need in a digital age, incapacity of the network to run a sophisticated financial organisation – and even the claim that there is enough retail banking competition already. The Government has said that instead of funding a Post Bank it believes the money would be better used maintaining and modernising the network to safeguard its future, to ensure that there will be no further program of Post Office closures.

But we know that if the Government does not work on a proper business plan with Post Office Limited then there will be hundreds if not thousands of post office closures because of falling revenues and no visionary commitment to the financial stability of the network. A Post Bank would demonstrate the interconnectedness of our productive economy – small businesses, high street enterprises and the local provision of goods and services – with a good and socially useful banking system.

Greater transparency of banking processes and a clearer understanding of what they do with our money could help drive the demand for more diverse banking. Four 'conditions for change' are necessary:

- Much greater diversity of banking for different needs
- Much greater transparency – either through regulation or legislation
- A break from the failed economic orthodoxy which dominated the financial structure in the UK up until the crash
- An end to excessive short-termism in investment

Localisation and competition: are banks able to meet the needs of business and industry?

> *"The economics of running a major retail network in the UK no longer stack up"*
> Michael Geoghegan, HSBC Chief Executive, 22 May 2009

The pattern of retail banking in the UK has been one of steadily reduced competition, and ever-increasing homogeneity on the high street. This process accelerated after the 'big bang' reforms of the 1980s, and in the wake of the credit crunch has accelerated again. The merger of Lloyds-TSB and HBOS, and the takeover of Alliance and Leicester, Abbey and parts of Bradford & Bingley by Santander left power further concentrated in the hands of a very few, very big banks.

The erosion of local and SME banking infrastructure

These few big banks operate at an ever-more profitable distance from the communities they are meant to serve, both in terms of personal knowledge of their customers and literally in terms of physical presence on the high street.

According to the Campaign for Community Banking, the number of bank branches in the UK is now just 9,094 – 43 per cent fewer than just 20 years ago.[14] The UK has 170 bank branches per million inhabitants (including building societies). This compares with 480 branches per million inhabitants in Germany and 1010 branches per million inhabitants in Spain.[15] Not only does Spain have more banks per head of population, they are also far better disbursed than they are in the UK.

Headline figures on the numbers of bank branches in the UK don't give the full picture. For many of the 1,500 rural and suburban communities that have only one or two bank branches left, even those branches may only be open for one or two days a week.

When banks close, the reduction in footfall on the high street often tips nearby businesses and amenities into decline too. Those that suffer most from loss of local facilities are the most vulnerable: older and disabled people, those with mobility difficulties, and carers.

And, when a branch is found to still be open, there are less people to deal with any queries we have. Figures from the British Bankers Association show that in the five years from 2003, Abbey reduced its staff numbers by 12,897, Lloyds TSB cut 15,058 staff and the Royal Bank of Scotland, 11,200. Since the BBBA data was complied, Lloyds TSB announced plans to make 11,000 more staff redundant and RBS announced plans for a similar number of cuts.[16] Following the takeover of HBOS by Lloyds in the wake of the financial crises, the combined group will have shed 45,000 jobs by 2014.[17]

This reduction in the bank branch network doesn't just mean a reduction in choice for consumers; it has also dramatically reduced the service provided to small businesses. Successive commitments by the big banks to increase lending to small businesses have been broken. In February, Barclays, HSBC, Lloyds Banking Group, Royal Bank of Scotland and Santander agreed to lend £190bn to businesses in 2011, with £76bn to small and medium enterprises. In May, it emerged that the banks had missed the £19bn quarterly lending target to SMEs by £2.2bn. And this wasn't the first time. Time and again the banks have committed to lending to small businesses, and time and again have fallen short of their promises.

The problem is one piece of obfuscation that gets in the way of everything else. Neither politicians nor the bankers will admit it – in fact they collude in this – but the big banks are no longer able to lend effectively to the SME sector. It isn't that they won't, it is that they have consolidated beyond the point where they are able to do so. They have no systems, no local managers, which would allow them to. Until the politicians accept this, and the bankers admit it – there will be no change.

Once the truth of the matter is admitted, an agreement with the banks that would help both sides could be negotiated. It would set out the contributions needed from them to set up a new community banking sector that is capable of lending to SMEs in key areas. In return, we would put an end to the argument that they should be lending more when we know they will not. Only when this is clear, can we work towards rebuilding a banking system that serves the needs of local communities and enterprises, and the productive economy.

Competition

The banking sector displays fundamental flaws in approximating to anything close to conditions of perfect competition. Indeed, the nature of banking is such that a laissez-faire approach will lead to less competition, not more, as a small number of over-sized and over-powerful institutions dominate the market.

Consolidation, takeovers and aggressive acquisitions left the UK economy with fewer banking institutions and the competitiveness of UK banks in terms of their product offering to UK citizens and businesses was neglected. They have been, to a greater or lesser extent, doing the same things and offering customers the same products. This destruction of diversity has had profound effects, including the erosion of local and SME banking infrastructure outlined above:

- The demise of relationship banking. 'Relationship-banking' has gone in to decline, as employees with direct knowledge of borrowers have been shed in favour of centralised IT systems able to deliver more 'efficient' computer ratings. However, homogeneity in approach to credit scoring leaves some sections of society underserved while decreasing system resilience as a small number of institutions chase the same group of customers and assess them in the same way.

- Choice for whom? The lack of access to finance. As institutions stopped specialising, either geographically or by market sectors, less profitable activities – such as maintaining a branch network and providing financial services for low-income people[18] – became ever more marginalised. As the number of bank branches and the variety of banking institutions in the UK has plummeted in comparison to other European countries, so meaningful choice and competition has declined for many. Countries such as Germany and France have a greater variety of banks, such as savings banks, co-operative banks, private banks, municipal banks and post banks that are firmly anchored in local communities. This helps explain the superior performance of these economies in providing access to fair finance for personal customers.[19] A broad network of municipal and regional retail banks in Germany and Switzerland dedicated to serving the needs of their local areas has ensured the maintenance and even expansion of credit to smaller businesses in those countries since the financial crisis[20] – an area in which the UK banks are still falling far short of expectations.

- Withdrawal of support from local economies. Nor is it just a question of access for individuals. Access to banking is vital to the survival of retail and other services in many medium-sized rural communities and in less well-off suburbs, estates, and inner cities. If active people and small businesses go to bank elsewhere, they are likely to spend elsewhere, too.

- Remoteness from local markets increases risks. As financial institutions grow they move further and further from their customers, and the knowledge of the products they are buying, selling or trading inevitably suffers. The fact that the crisis was sparked by an international market in subprime mortgages in the United States, about which very few had any real knowledge or great understanding, underlines this point.

- Diversity of ownership. Britain has a long and proud heritage of mutually owned financial institutions. The sector was demolished in the 1990's to little good effect according to an All-Party Parliamentary Group inquiry.[21]

The ICB report also provides compelling analysis of the lack of true competition in the banking market. However, their response lacks breadth. In particular it offers no remedies to barriers to true new entry. There are a number of evident Adverse Effects on Competition (AEC's) – factors or market features that serve to prevent, restrict or constrain competition. From the public and SME interest perspectives these AECs have led to record bid / offer spreads and significant price discrimination on

banking products at the particular expense of SMEs. Institutional restructuring and regulatory changes will have to go far beyond encouraging the creation of a new large challenger bank in the UK retail market.

But whilst there is a lot wrong, there is also a lot that can be done. A range of measures can help tackle the lack of localism and competition in the banking system:

- Public interest should be taken into account by the Commission, as per the Treasury Select Committee recommendation, and a full Competition Commission Inquiry is overdue

- The obvious difficulty of restructuring banks regionally, means that other innovations need to be looked at. For example, something along the lines of the Industrial and Commercial Finance Corporation, which preceded 3i – which the banks were shareholders of – could be reestablished with a very strong regional presence and regional accountability for lending to SMEs.

- At a more local level, an expansion of community development finance institutions would answer unmet demand. The UK could also learn from local banking in Germany and some parts of the US. A community reinvestment act, although not exactly the same as the US one, would give the regulators constructive powers.

- A greater diversity of institutions needs to be both facilitated and encouraged by the regulatory environment. Diversity of scale, location, ownership, and function would not only improve meaningful competition but would improve the resilience of the financial system. The government should seriously consider re-mutualisation as part of any forced demergers or sales by large banking groups. They should also remove the harsh and artificial constraints on the credit union sector, which is puny compared with competitor nations. While only about 0.5% of the adult population in the UK is member of a credit union, the equivalent figures for Ireland, the US, Australia and Canada are 45%, 30%, 20% and 16%, respectively.[22]

Banking for economic transition: are banks fit for the future and can pension funds demonstrate 'efficient' allocation over time?

Get banking right, and it could play a pivotal role in sustaining job-rich economic activity and providing the investment that is needed to drive forward the transition to a low carbon economy. Given that the banks are, even in times of stability, underpinned by the state there are a number of ways in which this could be used to irrigate finance for public benefit rather than extracting private profit.

For example, a risk reporting matrix could be introduced for pension funds. In the light of the huge impact of systemic volatility on pension funds over the past three years, they need to better understand that fiduciary duty means addressing systemic as well as stock risks. Governments need to make explicit their requirement that funds do this (as distinct from telling them how to do this). Requiring reporting on a matrix of risk areas would force them to analyse and expose long-term issues – including major ones such as climate change and carbon risk.

Case Study: a green investment bank to catalyse the shift to low-carbon Britain[23]

An estimated £55 billion per year is needed to invest in 'low carbon infrastructure and related supply chain' over the next decade and a half according to the green investment bank commission, chaired by Bob Wigley. That adds up to £750 billion needed by 2025 to help decarbonise the economy. A fully functioning Green Investment Bank (GIB) is required to help secure this investment, and can achieve it at least cost to the taxpayer and act as a catalyst for expanding the green economy.

It would help address market failures in the provision of appropriate finance by providing financial advice to Government, technical advice to projects/businesses, and by developing financial products to share risk and lever-in a diversity of sources of capital.

The risks involved combined with the scale of capital required over a relatively short time mean the capital needed will not be found without an Investment Bank explicitly designed for the purpose. Analysis by Ernst and Young indicates that for the energy sector, for example, only 10–20% of the capital required to 2025 will be secured without a GIB to facilitate capital flows. The GIB could leverage many times its capital base. Using existing public banks as examples, using shareholder capital:

- Caixa Geral de Depositos in Portugal (equity of e7.16bn) leverages x17
- ICO in Spain (equity of e2.38bn) leverages x22
- KfW Bankengruppe in Germany (equity of e13.1bn) leverages x31
- France's Caisse De Depots et Consignations (equity of e23.5bn) leverages x10.

All these organisations then achieve a further round of leverage through co-investment in projects with the private sector.

Bonds are an efficient way for the GIB to access the vast pools of lower cost institutional investors' capital. Other European public banks regularly use such bonds to back their investment plans. To help close the low carbon investment gap the GIB needs to have the power to issue its own bonds. Once fully established, with its own Statute defining day-to-day operational independence from Government, the GIB is expected to carry an AA or A rating. This lower rating means GIB bonds will not be competing with AAA-rated gilts, appealing instead to investors looking for investment grade products with slightly higher yields.

In the early years, however, it will be desirable for very modest issuances of GIB bonds (a few billion) to carry a statutory guarantee to establish them in the marketplace: in this case they will be AAA rated. Any conflict that may arise between issuances of GIB bonds and gilts can be managed through the Government's Debt Management Office (which issues gilts) being contracted by the GIB to raise GIB bonds for it. In its early phase the GIB should be set up as an on balance sheet institution with the ability to issue a modest amount of bonds that are guaranteed by the Government to create confidence in the absence of an investment track record. As the GIB develops an investment track record and a rating, explicit Government support can be removed and other investors invited to become shareholders and the 'mature' and off balance sheet GIB created.

To achieve a rapid shift in an economy governments need to use Government preferencing tools to better align political policy with financial priorities:

- tax credits
- guarantees
- on-lend to local banks, using their capacity for efficient distribution of targeted programs such as helping green businesses in the context of the green new deal
- regulatory support such as ruling out high-carbon investments

This applies most urgently to green economy transitions. The UK could draw on European models, like the KFW, which is the German bank that uses a range of preferencing tools to encourage investment in lending into things which are pro-social and pro-environmental. Hence, that means using tools such as cheaper credit, government guarantees, and tax treatments, innovating to make a positive difference to economic transition.

Shifting some entrenched shareholder imperatives, and changing limiting fiduciary obligation are also key to meeting our long-term collective interests. Where pensions funds are concerned, it should not be forgotten that pension savings are hugely tax subsidized, there is therefore a very strong public interest in encouraging a more enlightened view of Fiduciary obligation.

The Good Banking Summit and the Good Banking Forum

Many of the people and organizations present at the Good Banking Summit will have submitted evidence to the Independent Commission on Banking (ICB). This evidence can be found on the ICB's website.

This report is of proceedings and discussions at the Good Banking Summit. In its entirety it is not intended to represent the views of all those who attended. Rather its purpose is to highlight the work still outstanding that is needed to produce a banking system that is safe and fit for purpose. Also, and contrary to the way that the agenda for banking reform has to date been very narrow in focus, the Summit and this report are intended to demonstrate the breadth of issues that need addressing.

As a result of the Summit, the Good Banking Forum was set up to ensure continued debate of these urgent issues. The Forum's website can be found at: www.GoodBanking.org.uk

The Good Banking Summit was organized by **nef**, Compass and The Great Transition.

This report was written and compiled by Andrew Simms, with contributions from Tony Greenham, Ruth Potts, and Neal Lawson, as well as from many of the participants of the Good Banking Summit including: Prof Victoria Chick, Prof Prem Sikka, John Christensen, Catharine Howarth, Nick Mathiason, Tamasin Cave, Lindsay Mackie, Alan Hallsworth, Adrian Costain, Ann Pettifor, Josh Ryan Collins, and others.

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Dan Vockins, 10:10

Sian Williams, Toynbee Hall

Tom Wipperman, Independent Commission on Banking

Steve, UKuncut

The following people hoped to attend, but were unable to on the day and sent their apologies. Several helped in the subsequent preparation of this report.

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Alastair Wilson, School for Social Entrepreneurs

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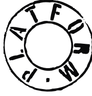
"Of all the many ways of organising banking, the worst is the one we have today."

Mervyn King, Governor of the Bank of England, 2010

The Good Banking Forum

The Good Banking Forum was set up to ensure continued debate of these urgent issues. The Forum's website can be found at:

www.GoodBanking.org.uk



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