



A Local Banking System

The urgent need to reinvigorate UK high street banking

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This is a briefing paper about the *other* urgent banking issue in the UK. It is an issue which has received so much less attention than other more familiar ones like lending or bonuses, reserve requirements or regulation. It is the issue of our missing local banking infrastructure, why it matters and what can be done about it.

Background

Most people are familiar with the manifold failings of the UK banking infrastructure. These might be summarised in this way:

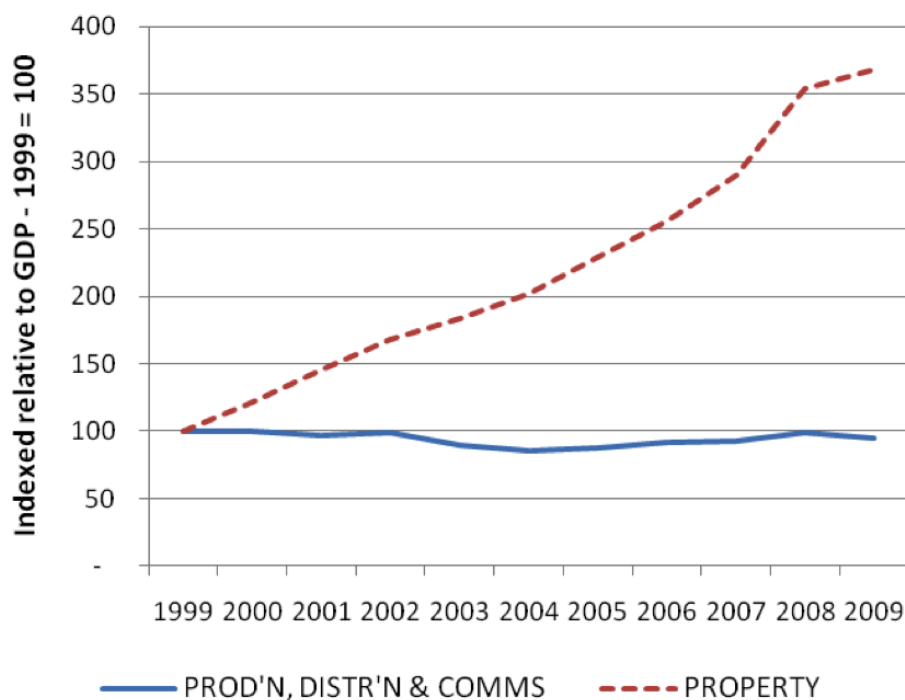
- They are decreasingly present on high streets: the number of bank branches is down 43 per cent in 20 years. There are often shorter opening hours in the branches that are left.¹ Access to banking is vital to the survival of retail and other services in many medium-sized rural communities and in less well-off suburbs, estates, and inner cities. If active people and small businesses go to bank elsewhere, they are likely to spend elsewhere, too. New research by the Cleveland Federal Reserve found that a physical bank presence makes it easier for customers to access loans – but also that those loans are less likely to default.²
- They drive money flows to the wrong places, encouraging money into speculation – including most property investment – rather than productive enterprise. The few big banks operate at an ever-more profitable distance from their customers, thanks to new, automated techniques such as credit scoring.
- They are failing to provide loans to small business, partly because they have replaced investment decisions based on local judgement with decisions based on credit scoring software. 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 apparently more ‘efficient’ computer ratings.

There are continuing arguments about the ability of the big banks to lend to small business, and claim and counter-claim about why small businesses are shunning banks, which is beyond the scope of this paper. The lending agreed under Project Merlin earlier this year was £1 billion behind by the end of September.

The issue of providing banking facilities to the unbanked is even more clear cut. As many as 1.5 million adults still lacking a current account – or 8 per cent of adults in the bottom quintile of income distribution. In both cases, the figures are well-known.

Less well-known – and central to the argument of this background paper – is the way the current system favours commercial property loans over productive business loans³ (see Figure 1).

Figure 1: Commercial property and productive business loans over ten year period 1999-2009



We have to assume that there are two reasons for this:

- The decision-making software used by UK banks finds property loans easier to evaluate than productive business loans, which usually require specialist or local knowledge, as set out above.
- There is a circularity of argument: property loans are more likely to lead to another asset bubble, which will benefit banks more than other kinds of recovery – if any bubble can be described as such – because of the proportion of property loans they have on their books.

This briefing sets out the case that the reason for this distortion is not just the monopolistic position of the big banks in the UK – there are smaller competitors emerging including Metro Bank, the Co-operative Bank and Virgin Money. It is that Britain is missing a critical sector of banking which its competitor nations have, and that this undermines the UK's ability to capitalise on its entrepreneurial culture.

The UK has 197 bank branches per million inhabitants (including building societies). This compares with over 500 and 1,010 branches per million inhabitants respectively in Germany and Spain.⁴ Not only does Spain have more banks per head of population, they are also far better disbursed than they are in the UK. The UK has 162 banks compared with France's 450 banks and Germany's 2,000 bank branches.⁵ Even taking into account factors such as greater population density and greater use of the internet for banking transactions, this difference is stark.

There are two historical reasons why British banking became so consolidated. The first was the flurry of banking takeovers in the early years of the twentieth century. Barclays alone took over 27 banks in the ten years before 1920.⁶

By 1918, even the Government was worried about this merger mania and appointed a committee of inquiry which urged them to legislate immediately. Being the British Government, trained in the art of taking no action for decades at a time, they agreed to drop the idea of anti-trust legislation on condition that there would be no more mergers between the big banks, and any other mergers should be submitted to the Treasury and Bank of England for approval.

There were then five big banks left: Midland, Westminster, Lloyds, Barclays and National Provincial. It was already the most concentrated banking infrastructure in the world. Six sevenths of British banks had disappeared during the half century to 1920.

This situation was then defended mercilessly by the governor of the Bank of England, Montagu Norman, during the Great Depression on the grounds that big banks were more likely to survive the upheaval than small banks. This is arguable, but there is no doubt that Britain avoided the banking disasters that overtook the USA in 1933.

Now, the UK banking industry remains highly concentrated with six large national banks, if we include the single remaining large building society, (Nationwide), accounting for 92 per cent of personal current accounts, 85 per cent of mortgages and 88 per cent of small business accounts.⁷

Efforts to increase competition have focused on creating new national challenger banks, and smoothing the way to new entrants from outside traditional banking, like Tesco and Virgin Money. This explains the £400 million loss made by taxpayers on the sale of Northern Rock to Virgin.

It is important to encourage competitors, but genuine competition requires some element of choice. This is not going to be real if all the choices are providing identical services, run in identical styles by similar systems. This is the crux of the argument. Other countries – our major trading partners and competitors – combine large universal banks with a substantial local community banking sector which has some or all of the following features:

- public or mutual ownership
- specific geographical area of operation
- explicit social objectives, including universal access to banking services
- local customer knowledge and decision-making over lending and provision of other financial products.

Although there are encouraging developments in the UK community finance sector, its overall scale and reach remain insignificant as a proportion of UK banking assets compared with Germany, Switzerland and the USA. These competitor economies have a major element of choice for banking customers which simply does not exist in the UK. It also goes some way to explaining why the UK lags other countries in achieving universal access to fair and responsible financial products and services. It also explains why the branch network continues to shrink leaving more communities unbanked, and why the controversy over whether large banks are fairly serving the needs of their small business customers remains unresolved.

The financial crisis prompted new interest in local and community banks among councils, and private consortia are in the process of setting up new banks. The Localism Bill and general power of competence for local authorities may offer opportunities to support the creation of community banks, but progress is extremely slow.

The question before us in this briefing is this. Is there a 'missing tier' in the UK banking system which could improve the social and economic performance of the industry? If so, how could this missing tier be developed in the UK, and would it emerge from, complement, or displace existing community finance institutions?

International experience

We are so engrossed in our own national banking experience, that it is difficult sometimes to imagine anything different. But perhaps it need not be completely impossible to imagine a world in which banks maintain or increase lending to small businesses during a credit crunch, without being bullied, begged or bribed by the Chancellor to do so, where they make modest but steady profits through both booms and recessions, and where they do not favour financial speculation or play the commercial property market over humdrum personal and small business banking.

It is not impossible to imagine this world, where there is a sector of the banking industry which is duty bound to serve all citizens and not leave the disadvantaged to the shady world of loan sharks and money changers – and where they are founded on the principles of encouraging savings among the poor and to support business start-ups. Because actually, the UK is exceptional in not having this sector to support its vital small business sector.

In the USA, the *Huffington Post* together with Rob Johnson, then of the Roosevelt Institute now at George Soros' INET, organised a successful campaign in 2009 urging people to 'Move Your Money' from the big banks responsible for the global crisis, and into small ones. It is a measure of how different the UK banking industry is in the UK compared to the USA, that this kind of consumer revolt would be impossible here. The reason is that UK banking customers have virtually no community sector banks to move their money to.

Of course, there is the Co-operative Bank or the Anglo-Dutch Triodos, for people in search of more ethical banking. There is also the new Metro Bank for those keen to use new entrants to the market. But none of these have their roots in specific communities, or have knowledge of them. None of them specialize in local lending, or have the knowledge and local roots they need to do it.

The demand for local banking is satisfied in countries like Italy and New Zealand partly by the existence of successful postbanks, with strong local roots. Again, the UK lacks anything along the same lines, and we have set out the case for post banking in a series of reports.⁸

This section will look in more detail at evidence from American, German and Swiss community banks. There are over 6,700 community banks in

the USA. They are independent, locally owned and operated institutions with assets ranging from less than \$10 million to multi-billion dollar institutions. The German Sparkassen network comprises 431 locally controlled banks with public interest criteria in their governing constitutions.⁹ There are 24 Swiss Cantonal banks which explicitly recognise both social and economic responsibility towards their customers, employees and sponsoring cantons.

Germanic banks

In the UK, over 80 per cent of mortgages are in the hands of the top five banks, as are over 90 per cent of Small and Medium Enterprise (SME) accounts. In comparison, 70 per cent of the German banking sector is in small or community banks. Characteristics of German municipal and Swiss cantonal banks include:

- a dual bottom line orientation
- mutually owned with stakeholder representation
- subject to the same regulatory framework as all other banks
- local branch decision-making and autonomy, local knowledge
- operate as part of a group system to pool risks and liquidity
- no risky investment activities or proprietary trading.

Both German and Swiss local banks remained profitable and continued lending throughout the financial crisis, while large banks made losses and contracted lending. German savings banks are obliged to serve any local customer not suspected of criminal activity.¹⁰ But there is dramatic evidence of the benefits of this kind of bank from Figures 2 and 3 showing return on capital and credit provision in German and Swiss banks over the period of the banking crisis.¹¹

In both cases, there is a stable line throughout the period that is represented by small banks. The large international commercial banks such as Deutsche Bank and Credit Suisse demonstrate volatile returns on capital, and rapid credit expansion followed by equally rapid credit withdrawal from the economy. The key point about these graphs is that the performance of the large international German and Swiss banks are analogous to the performance of the UK's big banks. But crucially, the UK entirely lacks a sector that can produce the stable lines of steady but moderate profitability, and careful and gradual credit expansion provided by those countries; local banking sectors. It is this local banking sector that has sheltered small businesses and individuals from the worst effects of the global financial storms.

The German savings banks, or Sparkassen, have been quietly showing their mettle since the financial crisis began. There are 430 of these banks, each of which is resolutely focussed on serving its local area. They overcome the disadvantages faced by smaller banks by acting as a group, providing mutual insurance and pooling certain financial services, such as leasing and factoring. Their combined balance sheet is over a trillion euros, and they have over 15,600 branches and 248,000 employees.

Figure 2: German Banks Return on Capital

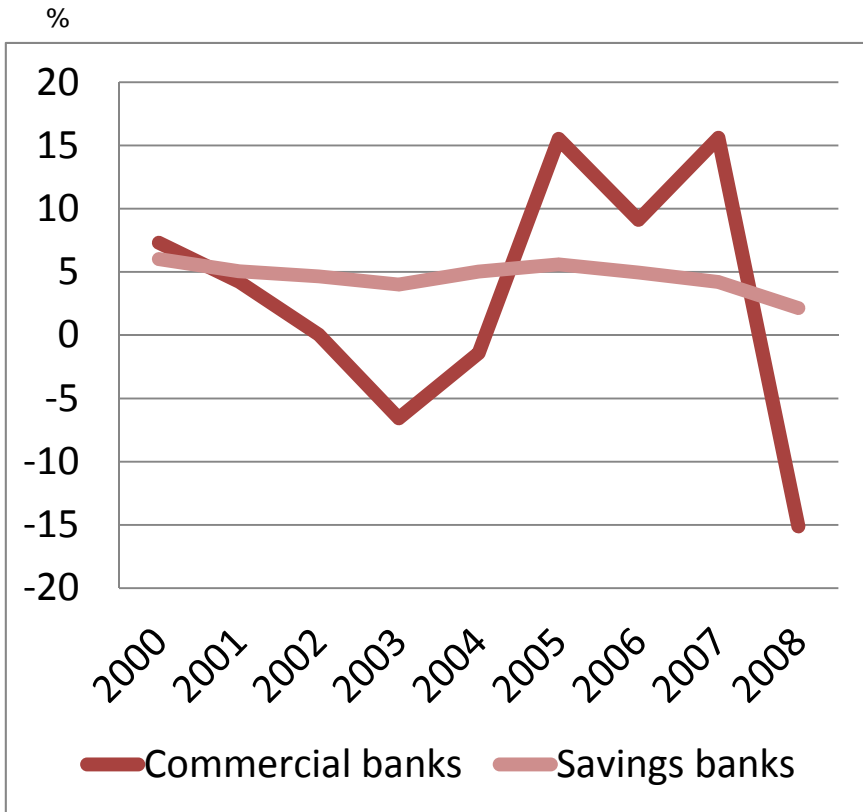
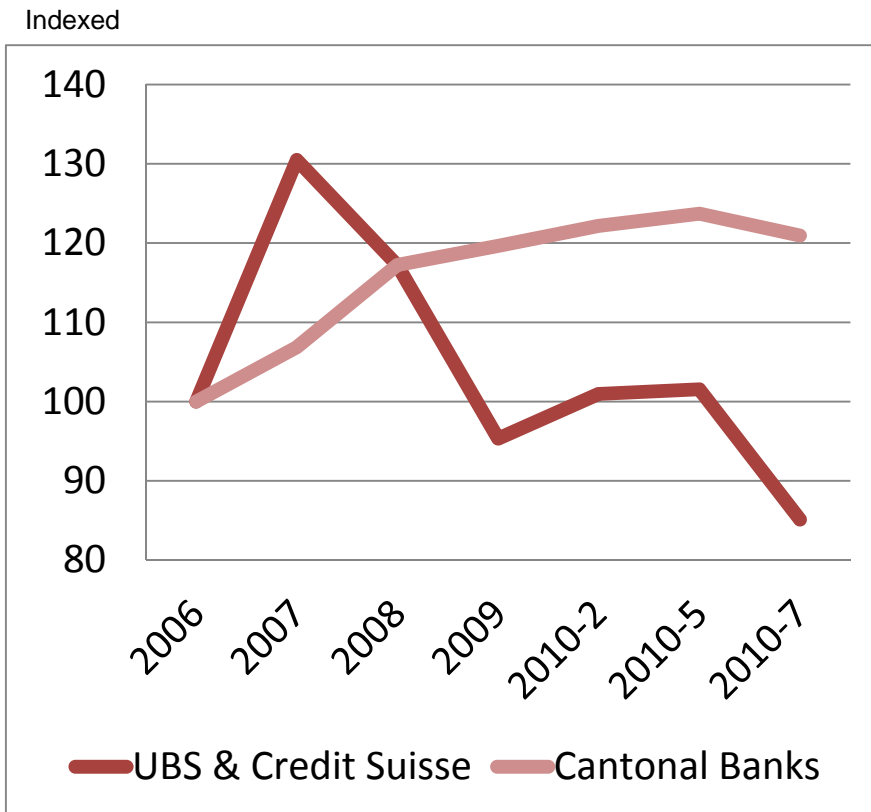


Figure 3: Swiss Banks Credit Provision



They are public interest institutions with explicit social as well as economic objectives. They are prudently managed, but also will back new business ventures and stay with customers for the long-term. Lending decisions are not made by computers, or sent to some remote regional office. Your branch manager has the authority to back his or her judgement.

It is true that the German banking system is not without its problems. The seven regional banks, or Landesbanken, did get into trouble during the last decade after Brussels forced the withdrawal of state guarantees from the sector in 2005. Chasing increased short-term profit, some invested heavily in structured credit products which went toxic in 2008. It would also be surprising if the prudent Sparkassen were to escape completely unscathed from the dire global economic situation faced by their personal and business customers. But they still represent a stability and usefulness to the real economy that is almost entirely lacking in the UK.

United States

Nearly half the deposits in the USA are lodged in small banks, which control approximately \$1.4 trillion assets. During the banking crisis of 2009, 124 small US banks closed – they were not considered too big to fail – but the vast majority rode out the storm.

These assets are likely to grow given the way that small banks are rising up the political agenda at state level. New Mexico passed legislation in 2010 requiring the state to shift public assets into banks based in the state, in order to make that money available for lending to local business. Similar proposals have emerged in places like Oregon and Los Angeles.¹² The reason for this political interest is that it is increasingly clear that smaller banks are far more effective at creating jobs. The 6,700 local banks have loans worth \$257 billion invested in small businesses and farms. The four biggest US banks have \$5.4 trillion in assets (40 per cent of the US total) but only \$85 billion in small business loans.¹³ US evidence suggests that big banks are not well-adapted to meeting the real needs of the economy. Worse, loans by big banks to large corporates helped them shed three million jobs over the past decade.

State banks

There has also been increasing interest in the idea of state banks, like the Bank of North Dakota. This was set up in 1919 – the same year that Neville Chamberlain launched the Birmingham Municipal Savings Bank along similar lines – in response to a wave of farm foreclosures at the hands of out-of-state Wall Street banks. It is profit-making, and has contributed over \$300 million in dividends to the state's coffers over the past decade. The main role of the bank is to partner with local banks to provide the loan finance for small business lending on specific deals.

Their lending portfolio of \$2.8 billion is mainly these participation loans, which allow local banks to make more loans. That is why North Dakota has 35 per cent more local banks than South Dakota and four times the US average.¹⁴ There have been no local bank failures since 2008 in North Dakota, and no bank in the state has more than 10 per cent of

local deposits – the existence of a powerful ‘partnership bank’ has succeeded in underpinning a diverse banking system there.¹⁵

Other states are planning similar institutions. Oregon, Washington and Massachusetts introduced bills in their state legislatures in January to launch their own state banks. Maryland has followed suit since. Illinois, Hawaii and Virginia are already looking into the idea. Virginia has gone even further, giving itself the power to issue its own currency in the event that the Federal Reserve defaults.

Community Development Finance Institutions

The CDFI sector in the USA has \$30 billion in assets, serving low income communities, both inner city and rural, with a specific remit for serving people who are financially excluded. The sector includes mainly community development banks and credit unions, which are involved with both lending and investing. There are also some community development loan funds, financing small businesses, housing and community service organisations, usually not for profit. There are also some community development venture funds.

The growth of the sector dates back to the Community Reinvestment Act in 1977 which laid duties on all financial institutions to lend in neighbourhoods where they were prepared to accept deposits. After 1995, the resources to CDFIs were hugely boosted because investment in CDFIs qualified as community reinvestment under amendments to the law.

The recession seems to have boosted the sector, with refugees shifting their money out of mainstream banking. The CDFI fund created by the US Treasury in 1994 also created a step change for them. The Bush administration tried but failed to eliminate the fund, but it has flourished under Obama. A \$3 billion CDFI bond programme is now being prepared, guaranteed by the federal government.

A major injection of \$100 million came from the federal government into the CDFI fund in 2009, designed for lending on, and the evidence suggests that this had largely been lent on within 90 days. This year, \$300 million will go into the sector from the fund to support small businesses.

US CDFIs also demonstrated lower default rates on loans to sub-prime borrowers than larger banks, indicating more responsible lending practices.¹⁶

Others

There are other alternatives to mainstream loans from big banks. Business barter is now worth \$10 billion a year and is particularly widespread in North America.¹⁷ Again, the Australian company Bartercard has a presence in the UK, but business barter is tiny here in comparison and charges can be high.

Mutual credit is another alternative, allowing small business very low cost credit using a parallel credit system. In Switzerland, this is known as WIR, set up in 1934, and is particularly widespread in the building and restaurant trades. It has 62,000 members, who can get low cost mortgages using the same system. The credit is fee-based rather than interest-based. Again, there is nothing similar in the UK.

The newest alternative is the C3 (Commercial Credit Circuit) system now used in Uruguay to help small businesses factor their bills, which they can do in return for credit in a parallel currency. C3 is being tested in other countries in Latin America, but is the brainchild of the Dutch NGO STRO, using funding from the European Commission.¹⁸ Again, there is nothing similar in the UK.

Possible ways forward

The clear implication of all this is that the UK is at a serious disadvantage compared with similar countries because it lacks that local banking sector that they share.

That is at least a tentative conclusion and it merits further research. Is there a genuine connection between the success and sustainability of new business start-ups and a viable local banking sector? Are there exceptions to that rule that need research? In depth analysis will also address questions such as: Does local governance or management allow for closer customer relationships and hence greater financial literacy and responsibility among customers? Does a community banking sector lead to greater access to transactional banking services? Is there a demonstrable beneficial impact on the local economy from having locally focused banks?

But these are not just important questions, they are urgent ones. If the UK is lagging behind the recovery, and if our small businesses are being starved of credit, then we need to know so that policy can shift to create the new local banking sector we need.

We already know that mainstream banking lacks the expertise to lend effectively to social enterprises, and we have known that for some time. We know also that there is a serious dearth of credit available for successful social enterprises that want to expand.¹⁹ The evidence here suggests some other conclusions, including:

- Conventional banking is not able to play much of a role in funding micro-businesses or in distressed communities, and the sooner we recognise that – and seek out alternative arrangements – the better.
- This is not primarily a problem of too little money – pension funds, local authorities and other public and philanthropic bodies all have long-term funds that need investment. It is a problem about a lack of funding institutions capable of putting the money to effective use.
- With the right central funding structures, local banks seem to have an extraordinary ability to get funds out into hard-to-reach communities, backing enterprise, very quickly.

The UK does have its own CDFI sector, led by flagship financial institutions like the London Rebuilding Society, the Aston Reinvestment Trust, the Wessex Reinvestment Trust and some of the new community banking partnerships. They specialise in providing personal finance for disadvantaged communities and business finance for SMEs and social enterprises, and their combined loan portfolio stood at £531 million at March 2010.²⁰ There are now 66 of these in 175 branches, though there were closures following the end of the Phoenix Fund in 2008. The CDFI sector has protected 8,600 jobs and 2,000 businesses.²¹

The credit union sector is made up of co-operatively owned institutions, promoting thrift and providing credit. They currently look after £600 million of members' savings. They have about £500 million out on loan. They are not currently allowed to offer services to businesses or to compete with banks. This is one of the artificial constraints on the sector, which is one reason it remains so puny compared with competitor nations. While only about 0.5 per cent of the adult population in the UK is member of a credit union, the equivalent figures for Ireland, the USA, Australia and Canada are 45, 30, 20 and 16 per cent respectively.²²

To put the £500 million loan portfolio of UK credit unions in context, large commercial banks can routinely execute a single syndicated loan transaction in excess of £500 million, particularly for mergers and acquisitions and property deals. The proportionate transaction costs are tiny compared with the hard work of managing millions of small loans. The bonuses, pay, promotion prospects and glamour are in a different league to the patient business of supporting a small business to flourish over many years. How can it be realistic to expect such activities to prosper within the same giant institution, sharing the same management, capital and culture as investment banking and global corporate banking?

Community banks, municipal banks, CDFIs and credit unions are important institutions, but we need many more of them. The question is how this might best be achieved. The following approaches deserve urgent attention:

1. Work with the Post Office to launch a postbank, along the lines of continental models.
2. Lift all constraints that prevent credit unions and CDFIs from competing with banks, another important and overdue reform.
3. Encourage and support local authorities in their bid to set up new kinds of local lending institutions which might provide safe long-term repositories for their money, especially borrowing from the concept of a 'partnership ban' – supporting local lending – that has been pioneered so successfully by the Bank of North Dakota.
4. Break up the banks currently in public ownership, releasing the old mutual sector that remain lost inside them and putting them back to work.

5. Borrow from US experience of the Community Reinvestment Act, and pass a similar duty on the big banks to compensate for their failure to provide the services the economy needs by funding a new banking sector that is capable of doing so.
6. Use the threat of CRA legislation to persuade the banks to organise this themselves, as an alternative to Project Merlin, in return for a final settlement of the argument about whether they are lending to the right places.

Some of these prescriptions are more obviously practical than others. But three shifts are absolutely imperative before any progress can be made towards a solution to this serious disadvantage that the UK economy faces.

First, we must recognise that our banking infrastructure is not fit for purpose when it comes to rebuilding local economies and supporting UK entrepreneurship.

Second, we must end the political pretence that we can force the big banks to lend more to SMEs, recognising that the real problem is that they no longer have effective systems with which to do so.

Third, having recognised that, we can then begin to build a political consensus about what must be done to fill this glaring and destructive gap.

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With thanks to: Tony Greenham, Joe Cox and Lindsay Mackie.

Cover picture: Edmittance via Flickr

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Registered charity number 1055254

© December 2011 **nef** (the new economics foundation)

ISBN: 978-1-908506-11-5



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