economics as if people
and the planet mattered

THE GREAT TRANSITION
Necessary Desirable Possible

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Response to ICB Issues Paper: Call for Evidence

Submission by **nef** (the new economics foundation)
to the Independent Commission on Banking

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"I believe that banking institutions are more dangerous to our liberties than standing armies."

Thomas Jefferson, US President 1801-9

"Let me issue and control a nation's money and I care not who writes the laws."

Mayer Amschel Rothschild (1744-1812)
founder of the House of Rothschild

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1 Executive Summary

Function and Purpose of Banking

1.1 Banking is unlike other industries and not subject to normal laws of free-market competition. This is because banks perform the fundamental function of credit creation that underpins the health of the whole economy, and as a result they enjoy a unique privilege of implicit and explicit government guarantees of their solvency.

1.2 The banking system has the potential to undermine the macro-economic management of the economy as well as having a pervasive effect on social and environmental stability. This justifies a broad interpretation of the Commission's terms of reference, and a statement of the function of banking as the point of departure. We offer the following definition: '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'.

Stability

1.3 Stability is undermined by an inherent contradiction between ensuring a stable monetary system that promotes the public interest on the one hand, and the control of the creation and allocation of credit by private banks on the other. Two broad reforming themes can improve stability: the dispersal of market power and increasing diversity within the banking system, and some form of direct control or strategic guidance over the quantity and quality of credit creation.

Competition

1.4 The banking sector does not approximate to anything close to text-book conditions of perfect competition. Indeed, the nature of banking as outlined above is such that a laissez-faire approach will lead to less competition, not more, and even improving competition cannot of itself address all forms of market failure. Without significant structural, regulatory, and monetary reform, it is hard to envisage how more competition will lead to anything other than more bad lending.

Choice

1.4 We argue that there is insufficient consumer choice with the current retail banking system, particularly when the extent of the range of suppliers ('choice of what'), and the extent of the range of customers served ('choice for whom'), are taken into account.

Reform proposals

1.5 We submit that the Commission should give greater priority to broad public interest than to the profitability of individual financial institutions where these conflict, and should:

- recommend reforms that introduce greater institutional diversity, in terms of function, location, scale and ownership. This would include consulting on a broader range of options for restructuring Royal Bank of Scotland before returning it to the private sector;
- recommend the introduction of full reserve banking, and;
- support the introduction of a UK Community Reinvestment Act

2 The Purpose and Nature of Banking

"Parts of the financial services industries need to reflect deeply on their role in the economy, and to recommit to a focus on their essential social and economic functions"

Lord Adair Turner, Chairman Financial Services Authority

"It is well enough that people of the nation do not understand our banking and monetary system, for if they did, I believe there would be a revolution before tomorrow morning."

Henry Ford (1863-1947), Founder of Ford Motor Company

2.1 The banking system is, by its very nature, not subject to the normal laws of market competition. Although the terms of reference set stability and competition as the primary subjects for the Commission's attention, we argue that the Commission should take a broad approach to these two issues. We believe it is necessary and desirable to start any review of banking with the question "What is the function of banking?" and we offer the following definition[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'

We argue that a fundamental redesign of existing market structures is required for banking to fulfil this function.

Why banking is a special case

2.2 Banking is unlike any other industry; this has been made abundantly clear in the current crisis. Banks have two major privileges that are not enjoyed by normal commercial businesses. The first is the ability to create credit - a fundamental function that underpins the health of the whole economy, and closely connected is the second privilege arising from the implicit and explicit government guarantees of banks' solvency (often referred to as moral hazard).

Credit Creation

2.3 In modern economies, through fractional reserve banking, banks play a key macro-economic role in the creation and allocation of virtually the entire money supply as credit. This is accepted by the Federal Reserve and the European Central Bank and by most monetary economists, although it does not feature in most general equilibrium models of the economy used by orthodox economists[2]. Private-sector commercial banks can thus be seen to provide a key public utility function as the originators and allocators of the money supply. We discuss this issue and how it might be addressed in Section 7, and its relevance to financial stability in Section 4.

Moral Hazard

2.4 The importance of credit creation leads inevitably to the bankers' second privilege, that risks are effectively underwritten by the taxpayer. This happens in two ways: in order to prevent the sudden loss of confidence that can lead to a run on the banks they are provided with a highly valuable deposit guarantee scheme funded at taxpayers' expense. This is compounded by the problem of institutions that are too systemically important to fail. One estimate of the value of this implicit guarantee in the UK, in terms of allowing banks access to cheaper capital, is over £50 billion a year[3]. This figure has swollen following the banking bailout because these banks would have faced significantly higher funding costs without the government interventions, but the pre-crisis figure for 2007 was still £11bn. Significantly, this value accrues almost entirely to the largest five banks[4].

An Incoherent System: Public Money, Private Banks

2.5 The government, via the Bank of England, has a monopoly on the creation of legal tender. The medium of exchange that forms an essential building block of any modern economic system is therefore limited to a single currency that allows no legally enforceable competitors. There are alternatives to a monopoly fiat currency, but discussion of these is outside the scope of this paper. What is relevant to the reform of the banking system is that the provision of a reliable and stable currency to fulfil the function of a means of exchange is a public good. But the advent of electronic banking and the demise of notes and coins (which now make up less than 3% of the money supply[5]) have resulted in money now mostly existing in electronic form as credit created by private banks. This could never have been envisaged by the architects of the 1844 Bank of England Act; this legislation was intended to explicitly prevent the creation of money by private banks by conferring a monopoly of issuance of notes and coins on the central bank.

Reversing the Presumption of Non-Intervention in Financial Markets

2.6 The function of credit creation and the separate but closely related function of credit allocation have significant economic, social and environmental impacts. The Bank of England's attempts to control retail price inflation does influence credit creation indirectly through interest rates and, more recently, quantitative easing, but it has no specific remit over asset price inflation. Essentially the quantity and allocation of money in the economy is determined by private banks. In other words the money supply is endogenous rather than exogenous, as assumed by some macroeconomic models.

2.7 Thus an inherent contradiction exists: a stable monetary system is a public good, money is backed by a state guarantee in the public interest and in this respect nationalised, but its creation and allocation is controlled by private banks motivated only by profit. It should hardly come as a surprise when private banks are bailed out by the taxpayer when the system crashes.

2.8 These features of banking make it more analogous to public utilities, natural monopolies and merit goods such as health and education, than to ordinary market sectors. Retail banking underpins economic activity and has a related impact on social inclusion. Access to basic transactional banking services is increasingly important for full economic participation and for social justice. For example, the cost of not having a current account and access to mainstream credit, borne by the most financially disadvantaged, can reach £1,000 per year[6]. Forcing people into the arms of loan sharks and confining them to the cash economy provides fertile ground for criminal operations and tax evasion.

2.9 Although 'public good' industries often incorporate market mechanisms and competition to great benefit, they are ultimately managed and regulated in the public interest and subject to democratic control. Broader economic, social and environmental goals take precedence over profit. We would argue for this reason alone that the structure of the banking market, the level of financial returns, the number of market participants and their scale and scope, are all appropriate and indeed essential subjects for regulation.

2.10 However, there is also a highly significant lesson from the financial crisis about the theoretical basis for the deregulation of financial markets: the free-market approach to financial markets as a basis of policy and regulation is deeply flawed. This was encapsulated by the testimony of Alan Greenspan given on 23 October 2008 to the House Committee on Oversight and Government Reform of the US House of Representatives. Part of an exchange between him and Representative Henry Waxman of California, chairman of the committee, is repeated overleaf[7].

Waxman	"You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. Do you feel that your ideology pushed you to make decisions that you wish you had not made?"
Greenspan	"…Yes. I've found a flaw. I don't know how significant or permanent it is. But I've been very distressed by that fact."
Waxman	"You found a flaw in the reality."
Greenspan	"…[A] flaw in the model that I perceived as the critical functioning structure that defines how the world works, so to speak."
Waxman	"In other words, you found that your view of the world, your ideology was not right. It was not working."
Greenspan	"Precisely. That's precisely the reason I was shocked…"
Greenspan (later)	"This modern risk-management paradigm held sway for decades. The whole intellectual edifice, however, collapsed in the summer of last year..."

2.11 For three decades there has been a presumption of well-functioning markets in financial services that has justified a deregulatory agenda and been used to resist government intervention in banking as being damaging almost by definition. However, the testimony of Greenspan and the experience of the financial crisis provide evidence that the presumption against government intervention should be reversed, or as monetary economist Richard Werner puts it, "This sharply lowers the hurdles for government intervention to become beneficial to society"[8]. A practical result of such a reversal of presumption would be to shift the burden of proof on to banking institutions to demonstrate why mergers and acquisitions (above a certain scale), and combining retail and investment banking, were in the broad public interest, rather than simply in the narrow interest of shareholders and senior employees.

Conclusions and Recommendations

2.12 Banking is unlike other industries and not subject to normal laws of free-market competition, because banks perform the fundamental function of credit creation that underpins the health of the whole economy. As a result they enjoy a unique privilege of implicit and explicit government guarantees of their solvency. Stability is undermined by an inherent contradiction between ensuring a stable monetary system that promotes the public interest on the one hand, and the control of the creation and allocation of credit by private banks on the other. Government intervention and regulation is the only way to square this circle and we argue that one of the key lessons from the financial crisis is that the presumption in favour of deregulation should be reversed. Public interest should be the test and it can no longer be presumed that a *laissez-faire* approach to the structure of the banking industry will meet this test. Therefore we argue that the Commission should start from a definition of the function of banking that explicitly recognises economic, social and environmental goals and the desirability of democratic oversight and accountability for the banking industry.

3 Comments on Scope and Responses to Questions

"Of all the many ways of organising banking, the worst is the one we have today[9]."

Mervyn King, Governor of the Bank of England

For the reasons outlined above, we would argue that the Commission's Terms of Reference have been too narrowly drawn and as a result there is a danger that final proposals will fail to deliver a banking system that promotes prosperity in the real economy and supports socially and environmentally useful activities, or at the very least does not support socially and environmentally damaging activities.

Question 1.1

3.1 *What is the relationship between the Commission's two primary objectives of financial stability and competition (including consumer choice)? Are these goals fundamentally in harmony? If not, what are the tensions between them and how can reform proposals be designed to alleviate the tensions?*

The two primary objectives are not necessarily in harmony or conflict. What will determine this is the nature of the competition and the way in which it is defined. As we argue in Sections 4 and 5, true competition requires institutional diversity and the dispersion of market power.

In terms of domestic retail banking, competition could be considered to be present in a system where a sufficient number of banks vigorously chase the same large group of customers with similar product offerings that are keenly priced relative to one another, and where the market appears dynamic in terms of frequent changes in prices and services. This is where we are today, and where we were before the financial crash.

In this case competition would not contribute to stability and might undermine it to the extent that a small number of large banks converge on a similar portfolio of customers and products. The system is more vulnerable to shocks if the bulk of the system is made up of a small number of large constituents who all have similar exposures to the effects of the shock.

The keys to financial stability are to build the resilience of the system to shocks, and to counter pro-cyclical tendencies. Ensuring a diversity of institutions and dispersal of market power are more likely to deliver such stability, and this is examined further in Section 4.

Question 1.2

3.2 What weight should the Commission give to the other objectives – on lending and the pace of economic recovery, competitiveness, and risks to the Government's fiscal position – in its analysis?

We suggest the secondary objectives be considered as follows:

- ***Lending and the pace of economic recovery***. This criterion should be broadened to include the sectoral and geographical composition of credit allocation in line with the Government's stated objective of rebalancing the economy both regionally and in terms of industry sectors.
- ***Competitiveness***. The phrasing of this criterion in the Terms of Reference seems to contain implicit assumptions that the UK sector's international standing equates to domestic competitiveness, and secondly that the international competitiveness of the UK's financial and professional services sectors is synonymous, or at least consistent, with the competitiveness of the wider UK economy. These assertions would need to be tested in our view, as there are *prima facie* reasons to suggest that the two objectives of international competiveness of individual UK financial services firms and the international competitiveness of the UK economy overall might conflict. It is beneficial for an individual UK-based

firm to achieve maximum scale and scope to compete internationally, particularly with a profitable domestic market providing a bedrock to its international expansion plans. But there is no inherent reason why the positive benefits of overseas earnings from global UK banks will necessarily outweigh the potential raised costs to domestic industry of an oligopolistic banking sector. The Government's own focus on ending over-dependence on financial services implies that such conflicts might exist. The UK may have been suffering from a form of financial 'Dutch disease', where a single dominant sector of an economy can inadvertently distort general economic conditions to such an extent that other sectors are undermined. This famously occurred in the Netherlands upon the discovery of natural gas deposits. This valuable export sector drove up the value of the Dutch currency, making exporters and manufacturers in other sectors less competitive, and worsening the general balance of trade. Even if there is no causal link between the expansion of financial services and the decline of other industry sectors, the relative decline of non-financial sectors has been easier to view as non-problematic as long as the City continued to grow.

- ***Risks to the government's fiscal position***. There are two sources of risk to the government's fiscal position: the deterioration in the public sector borrowing requirement that results from sharp recessions associated with banking booms and busts, and the additional cash (ie bail-outs) and notional (ie value of free insurance) costs of guaranteeing banks' solvency. We believe that any reforms must seek to reduce both of these risks both from the point of view of the primary objective of stability, but also from the point of view of the broader economic, social and environmental definition of the purpose of banking that we take as our starting point.

Question 2.1

3.3 *Are there other broad options for reform that should be added to this framework?*

The option of returning the power over creation of new money from private banks to the central bank should be explicitly considered. This reform allows transaction banking services to be separated from the functions of intermediating between lenders and borrowers and maturity transformation. It removes the need for taxpayer guarantees and solves the problem of moral hazard. It reduces the likelihood of debt driven asset bubbles and banking runs. Therefore it directly addresses the primary objective of stability, and the secondary objectives of risks to the government's fiscal position. It also indirectly addresses the primary objective of competition by removing the cross subsidisation of 'free' current accounts, thereby lowering barriers to entry and improving transparency for the consumer.

This broad option for reform is considered further in Section 7 of this submission.

Question 2.2

3.4 *Which (if any) of the reform options identified in the above framework most deserve further development, specification and analysis?*

Reduction of market concentration and the separation of transactional banking services from other banking services. The latter is addressed to varying degrees by the listed options of 'Separation of retail and investment banking', 'Narrow banking and limited purpose banking' and 'Structural separability, including living wills and resolution schemes', however it is best addressed by the full reserve banking proposal mentioned above and in Section 7 of this submission.

Questions 3.1 & 3.2

3.5 *What would the benefits of these options be, in particular for financial stability and competition? How can these benefits be quantified?*

What would the likely costs be of the various options? For example, what lost efficiencies might there be if banks were required to reduce the range of activities they could undertake, and/or their size? How can these costs be quantified?

The example given suggests a presumption that large and diversified financial firms are necessarily more efficient; if any is to be made, we would make the exact opposite presumption, that large and diversified financial firms are likely to suffer from diseconomies of scale resulting from management inefficiencies of bureaucracy, remoteness from customers, and lack of focus.

We recommend that the framework of Social Return on Investment (SROI), as endorsed by the UK Cabinet Office[10] be used to quantify the full costs and benefits, including social and environmental externalities of reform proposals compared with the current system.

As leading practitioners in this field we would be pleased to submit such analyses once the commission has shortlisted its preferred options for reform.

Question 3.3

3.6 *What are the implications of the role of the (less regulated) shadow banking sector for the Commission's work? To what extent would the different reform options simply shift problems from the banking sector to the shadow banking sector?*

This is potentially a serious problem. We argue in this submission for a reversal of the presumption that free markets are always effective in favour of a presumption that regulation is necessary unless it can be established on a case-by-case basis to be counter-productive or undesirable. This would provide a general protection against risky and systemically dangerous activities moving into the shadow banking sector.

Question 3.4

3.7 *Should any of the broad options be ruled out as impractical? If so, why?*

No. First, it is too early to rule out any options and secondly the practicality of proposals (a process issue) should be considered only once their desirability, or lack thereof, have been established on the basis of expected outcomes.

4 Stability: A broader definition

"[In the Middle Ages] the biggest risk to the banks was from the sovereign. Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed."

Andrew Haldane, Executive Director of Financial Stability at the Bank of England

4.1 The Commission's Issues Paper states that it will "also have regard to the Government's wider goals of financial stability and creating an efficient, open, robust and diverse banking sector". We argue here that the goal of financial stability must take account of the special nature of banking discussed in Section 2. In particular it must first recognise the role that the banking system plays in creating the supply of money, and controlling the allocation of investment capital and purchasing power within the UK economy. It flows from this power that the banking system has the potential to undermine both the macro-economic management of the economy as well as having a pervasive effect on economic, social and environmental stability and the Government's democratically endorsed policy objectives across these areas. This is why we believe the Commission should endorse a broader concept of stability that is founded in the definition of the purpose of banking that we set out in Section 2 – one that explicitly incorporates economic, social and environmental goals. It also provides a powerful justification for returning the power of determining the overall quantity of credit creation to the central bank instead of being the emergent consequence of millions of individual lending decisions.

The power of credit creation

4.2 Annex 1 of the Commission's Issue Paper describes banks and how they work, and states in paragraph 19 that:-

"A bank funds itself by incurring liabilities – most notable customer deposits and debt (wholesale funding) – and uses these funds to make loans and investments which appear as assets on its balance sheet."

We believe that this does not accurately describe the process of credit creation, and argue that precision on this point is vital.

4.3 Banks do not 'wait' for deposits before issuing loans and they do not use these funds to make loans and investments. Rather, deposits are created by bank loans. These can be created simply by typing them into a (computer) ledger when a depositor asks for a loan.

4.4 Recognising the true nature of this process fact has proved very problematic. As Joseph Schumpeter put it in 1954:

"It is much more realistic to say that the banks 'create credit', that is, that they create deposits in their act of lending, than to say that they lend the deposits that have been entrusted to them......Nevertheless, it proved extraordinarily difficult for economists to recognise that bank loans and bank investment do create deposits... ...This is a most interesting illustration of the inhibitions with which analytic advance has to contend and in particular of the fact that people may be perfectly familiar with a phenomenon for ages and even discuss it frequently without realising its true significance and without admitting it into their general scheme of thought."[11]

4.5 The fact that banks create credit in this fashion means that the money supply is endogenous to the economy; the most likely factors affecting banks' willingness to lend are their view of the quality of their existing assets, in other words the probability of existing debts going bad, and expectations about future economic conditions, in other words the viability of new lending. Hence changes to capital reserve requirements – as suggested in Basel III reforms for example – may have very little effect on banks' lending patterns and changes to the central bank base rate may also have a negligible effect, as was demonstrated in Japan in the 1990s and is being demonstrated in the UK today.

Implications for institutional reform

4.6 **nef** has been advocating a series of reform proposals which are documented in previous publications[12] and for brevity we do not reproduce them all here. In broad terms, we believe that the importance of the power of credit creation is such that either this power needs to be widely dispersed **between** a broad range of institutions serving different constituents of society and the economy, or it needs to be tightly regulated **within** individual institutions, or both. First, we examine the potential for a focus on a "diverse banking sector" to disperse market power and its utility as the guiding theme for institutional reform.

Diversity of function

4.7 We need financial institutions to focus on specific functions and to do a good job, not to chase short term profit maximisation. Retail banking is a very different business from investment banking, but universal institutions that devote large resources to speculative activity put at risk their ability to provide core functions for their customers – payments, settlements, savings and loans. We support a return to the division of investment banking from retail banking.

4.8 Government must see through its commitment to the creation of a Post Bank, Green Investment Bank, and Big Society Bank, which we suggest should be based closely on the recommendations of the Social Investment Task Force for a Social Investment Bank[13]. However, we would also benefit from banks that focus on particular industries, customers and products. State ownership of Royal Bank of Scotland could be used as an opportunity to create many new banking institutions along these lines, and we recommend that a public consultation be set up to seek and examine a broad range of views on how these assets should be most advantageously returned to the private sector.

Diversity of scale and location

4.9 Large banks, or rather banks that can service large customers, have their place in the ecology of finance, but we need many more smaller and medium sized banks that are not too big to fail. We need regional and local banks with the particular knowledge, experience and culture of the areas they serve. This notion is not fanciful as competitor economies with less concentrated banking sectors demonstrate. A vibrant Community Development Finance Institution sector should be encouraged by introducing a UK version of the US Community Reinvestment Act which would provide greater transparency over where banks deploy their capital – or more to the point where they choose not to.

Diversity of ownership

4.10 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[14]. 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, and create a more level playing field for credit unions. 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[15].

Key benefits of diversity

4.11 Greater diversity in the banking sector would:-

- help ensure that less profitable activities are not left behind by re-introducing more variety in ownership of banks and hence ensuring different expectations of levels and speed of financial returns, and by encouraging institutions with more focussed objectives, such as a focus on a particular locality, social-economic group or product;
- provide greater clarity to savers about the use of their deposits and the potential risks and returns associated with a bank;
- allow greater management focus at Board level on areas of banking that are considered overtly or covertly to be poor relations within large universal banks, and help reconnect senior management with high-street customers. It is not reasonable to expect a deep experience of all the different functions of banking to exist at the senior management or Board level of a global universal bank. Bob Diamond may be an excellent deal-maker but he is hardly steeped in the culture of lending to small businesses in Bradford. Such cultural factors may not be quantifiable in their impact but they matter;
- allow more focussed micro-prudential oversight by aligning different banking activities more closely with different institutions allowing risky sectors and activities to be monitored more at the institutional level, and;
- assist macro-prudential oversight and promote greater system resilience by creating 'fire-walls' between different parts of the system.

Strategic credit regulation

4.12 In addition to institutional reform based on the goal of diversity and dispersal of market power, we argue that financial stability requires greater control by the central bank over the quantity of credit creation. In addition, broader economic, social and environmental stability require greater control over the allocation of credit within the economy in terms of overall strategic guidance.

4.13 We suggest the central bank takes a much more proactive stance in monitoring the quantity and allocation of credit created by commercial banks. For many years, 'credit guidance' or 'window guidance' was standard practise not only by central banks' in developing countries but also in developed countries, including Japan, Germany, France, the United States and the UK[16] [17] [18]. There is considerable evidence to suggest that the East Asian 'economic miracle' was built on the back of such credit guidance policies, involving central banks directly influencing the quantity and allocation of commercial banks' lending, directing the credit towards those industry sectors that the state felt would lead the fastest and most efficient forms of growth and development.

5 Competition: How deregulation destroys competition and stability

> *"Removing controls over the finance sector paved the way for its rise to dominance… Financial institutions, we contend, no longer act as servants to the real economy but as its masters…"*
>
> *"'There will be a collapse in the credit system in the rich world, led by the United States, leading to soaring personal and corporate bankruptcies…[in which case] the probability of a financial crisis rises appreciably."*
>
> **nef**, Real World Economic Outlook (2003)[19]

5.1 The banking sector does not approximate to anything close to text-book conditions of perfect competition. Indeed, the nature of banking as outlined above is such that a *laissez-faire* approach will lead to less competition, not more, and even improving competition cannot of itself address all forms of market failure. The longer perspective on the lead up to the present financial crisis shows the dangers of judging all policies by the yardstick of competition. An incremental approach to liberalisation and competition was formally set in motion with 'competition and credit control' in 1971 and has appealed to competition on numerous occasions ever since. Without significant structural, regulatory, and arguably monetary reform, it is hard to envisage how more competition will lead to anything other than more bad lending.

Deregulation destroys competition

5.2 Policy on banking regulation has been largely based upon assumptions, derived from neo-classical economics, of perfect competition and information that have no basis in reality. A rigorous and objective review of competition in the banking sector must start without making such deductive assumptions about how economies and markets work based upon hypothetical models of general equilibrium. It should take a more inductive approach based upon empirical evidence of what is actually happening in the sector.

5.3 Over the last three decades, regulators became exceedingly relaxed about competition in the banking sector, relying on the UK sector's international standing as proof of its competitiveness. Policy permitted an ever more homogeneous and top-heavy sector to develop. 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.

5.4 The sheer profitability of the financial sector makes it clear that the system is not competitive in the usual meaning of the term. Competition is meant to ensure that the lure of high profits will attract new entrants who will offer products at a cheaper price. The fact that this has not occurred suggests that there are major barriers to entry and that incumbent institutions are operating in an oligopolistic[20] rather than in a competitive market. Over 85% of current accounts are now concentrated in the hands of the big five banks[21]. This destruction of diversity has had profound effects:

The demise of relationship banking

5.5 These few big banks operate at an ever-more profitable distance from their customers, thanks to new, automated techniques such as credit scoring. '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.

Distorted incentives and short-termism

5.6 The recent problems in the system have been compounded by the way in which traders are remunerated on a very short-term basis, creating incentives to maximise short-term returns. Similarly, the financial 'engineers' creating new products for the derivatives market are often paid immediately for the returns forecast over the whole term of the product. This creates potentially destructive incentives to develop products with a long 'tail' of risk.

5.7 Institutions have converged on those activities that offer the highest returns, particularly over the short time horizons against which performance is generally judged in listed companies[22]. There is little to be gained from accepting lower returns now to move into sustainable long-term sectors that may ultimately produce higher returns, if all your shareholders have left in the meantime for rivals posting better quarterly results.

Economies vs diseconomies of scale: Increasing returns means increasing risks

5.8 While economies of scale are important, they also bring dangers. The concept of ‘too big to fail’ is well-documented and tends to allow returns to be increased by increasing the risk to the taxpayer. Crucially, the theory of diversification of risk through universal banking has shown to not hold true when a small number of very large banks all converge on similar portfolios. Shareholders should have control over their own risk diversification and have a broad range of divergent institutions in which to invest.

5.9 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.

6 Choice for Whom, and of What? Social and environment factors

"The question is not 'are people credit-worthy?' but 'are banks people-worthy?'"

Muhammed Yunus, Grameen Bank, 1976

6.1 We argued earlier in this submission that the Commission's terms of reference have been drawn too narrowly and that social and environmental factors should be explicitly acknowledged as relevant to the function of banking. This is illustrated by the lack of sufficient consumer choice with the current retail banking system.

6.2 In contrast, a broader diversity of different types of bank and a dispersal of market power away from a few large banks would

- provide customers with a much broader range of *suppliers*, as well as *products*, and
- provide suppliers that collectively focus on a much broader range of *customers*.

Choice of What?

6.3 For example, in terms of the range of suppliers, a customer who wishes to bank with a large but domestically focused bank, because they feel size confers security but wish to limit exposure to overseas markets, has a choice of two: Lloyds Banking Group and Nationwide. For business customers this choice is reduced to one (Lloyds).

6.4 Similarly, if a customer wishes to know that their savings will not be used to support lending to certain industries such as arms manufacturers or projects that are environmentally destructive, they have a choice of four: Co-operative Bank (including Smile), Triodos Bank, Ecology Building Society and the Islamic Bank of Britain[23]. Lifting the constraints of the credit union sector would add a significant new strand of consumer choice in this regard, as savings are recycled locally.

6.5 And yet recent market research conducted by EIRIS[24] revealed the unmet consumer demand for greater transparency and choice over banking products. When asked what might encourage them to switch to an ethical financial product or service:

- 38% would be more likely to change if more information was available on the high street about ethical/green products
- 43% said they would be more likely to switch to an ethical financial product if its green and ethical credentials were externally verified so that it was easier to trust the claims made
- 41% would be more likely to change if a greater choice of ethical/green products was available
- 37% would be more likely to change if there was more information available on how green/ethical products make a difference in the world

Choice for whom? The lack of access to finance

6.6 In terms of the range of customers for which competitive products, or indeed any products, are offered, our research on financial exclusion suggests that the existing system fails to ensure adequate provision of banking services to significant sections of the population.

6.7 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[25] – became ever more marginalised. The spatial and social dynamics of branch closure are important. Academic research shows that branch reductions have generally been greatest in more deprived and ethnically diverse areas, and lowest in more affluent ones[26]. This means that where finance is available, it is often on exorbitant terms – a typical APR from the legal end of the home credit market, is 272 percent[27].

6.8 According to the Campaign for Community Banking, the number of bank branches in the UK is now just 9094 – 43 per cent fewer than just 20 years ago[28]. The UK has 197 bank branches per million inhabitants (including building societies). This compares with over 500 and 1010 branches per million inhabitants respectively in Germany and Spain[29]. 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[30] compared with France's 450 banks[31] and Germany's 2,000 banks[32]. Both countries have a variety of banking forms, 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 is providing access to finance[33].

6.9 And, when we find a branch that is still open, there are fewer people to deal with any queries we have. Figures from the British Bankers Association (BBA) 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 BBA data was compiled, Lloyds TSB announced plans to make 11,000 more staff redundant and RBS announced plans for a similar number of cuts.[34]

Withdrawal of support from local economies

6.10 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[35]. If active people and small businesses go to bank elsewhere, they are likely to spend elsewhere, too. Those that suffer most from the loss of local amenities are the most vulnerable: older and disabled people, those with mobility difficulties, and carers.

7 Full Reserve Banking: Who should create money?

> *"The essence of the contemporary monetary system is creation of money, out of nothing, by private banks often foolish lending. Why is such privatisation of a public function right and proper, but action by the central bank, to meet pressing public need, a road to catastrophe?"*
>
> Financial Times columnist, Martin Wolf[36]

7.1 In our separate joint submission with Professor Richard Werner and Positive Money, we set out what we consider to be the most effective policy for the creation of a more stable banking system: full reserve banking. The key points are repeated here.

7.2 We believe that the banking sector would be more stable and robust under a full-reserve banking model, where the transactional function of banking (the payments system) is separated from the lending function, than under the current business model, which is often labelled 'fractional reserve banking'.

7.3 We also believe this reform would create greater competition within the banking sector, by hugely reducing the barriers to entry in the retail sector. In particular, we would hope to see it made much easier for new, 'Transaction Account'-only banks to enter the market to increase competition in the provision of this core payments system service. We also believe this reform would support the development of a more diverse financial services sector, placing institutions such as credit unions and traditional building societies on a level playing field with banks.

7.4 The key feature of fractional reserve banking is that the lending activity of banks effectively creates new money, in the form of new bank deposits. In contrast, in a full-reserve banking system, the effective money supply is unaffected by the lending activities of banks. An economy running on a foundation of full-reserve banking will be less prone to pro-cyclical tendencies and less inflationary than an economy based on fractional-reserve banking.

7.5 Our proposal for full-reserve banking ensures that risk-free deposits in the payments system do not coexist with risky assets. The proposal to achieve this is simple: we simply require that banks keep safe the money which customers wish to keep safe, and invest only the money that customers wish to invest. These changes would give customers a truly risk-free method of holding money and thus remove the need for taxpayer-funded deposit insurance.

7.6 Our proposal modernizes those put forward by Irving Fisher (1936), Milton Friedman (1960), and James Tobin (1987). It follows Huber and Robertson (published by nef in 2000) in recognizing the digital nature of modern money, and is designed to cause the minimum amount of disruption to the financial system's computer networks and IT infrastructure. This proposal is easy and inexpensive to implement – certainly much cheaper than a second bailout, and less disruptive to the City than a new 'Glass-Steagal'-type Act. It merely makes banks operate the way people (including many economists) assume they operate already – as true intermediaries between savers and borrowers. By doing so, it removes one of the primary sources of economic instability.

8 UK Community Reinvestment Act

> *"There is a critical need for sustainable investment in poorer communities if free market societies are to maintain cohesion."*
>
> Sir Ronald Cohen, Chairman, Social Investment Task Force

8.1 We recommend the introduction of a Community Reinvestment Act (CRA) modelled loosely on the US act of the same name and adapted for UK circumstances.

8.2 The CRA monitors the level of lending, investments, and services in low and moderate income communities excluded or under-served by the mainstream financial sector. The legislation requires regular examination and a grading of a lending institution's activities in poorer communities and has penalty mechanisms, including barring merger activity, if a lender is neglecting its community by extracting deposits without reinvesting through loans and branch presence

8.3 Evidence suggests that the CRA has driven the growth of community finance development institutions (CDFIs) in the USA, and that a vibrant CDFI sector can effectively complete the jigsaw of private sector finance in areas where both small businesses and individuals are underserved.

8.4 Arguments that the CRA helped to cause the sub-prime crisis in the US are refuted by evidence which in fact enhances the case for the CRA, revealing it as part of the solution to responsible and sustainable lending practices rather than part of the problem.

8.5 By entrenching principles of transparency and fairness in the banking system and tackling financial exclusion for individuals and small enterprises, the CRA can thereby ensure fuller participation in economic life and enhanced opportunities for disadvantaged communities and so simultaneously promote social justice and economic efficiency.

8.6 We believe that by a UK CRA could stimulate greater choice and competition in the provision of banking services to both individuals and SMEs, particularly in disadvantaged areas where stimulating local economic growth is essential to the Government's stated aim of rebalancing the economy. In the US the Act helped to leverage private investment of 27 times the $800m of federal money invested in the sector, thereby effectively 'filling in the gaps' of solely private provision.

8.7 We have included a more detailed examination of the arguments and evidence for a Community Reinvestment Act as Appendix A of this submission.

9 About nef (the new economics foundation)

"A smart prime minister would follow the advice of the New Economics Foundation in its Better Banking campaign and direct the nationalised banks to lend more to green start ups and other companies that could kick start Britain's industrial renaissance. Instead, Mr Cameron yesterday promised only to keep talking to the bankers and their lobbyists."

The Guardian, Editorial on 29 May 2010

nef is one of the largest and most prominent think-tanks in the UK, and one of the leading organisations in the world developing an economics which puts people and planet first. We have been pioneers in promoting new economics thinking and practice for 25 years.

Many of the early ideas **nef** promoted – green taxes, alternative economic indicators, ethical investment and social auditing – have become mainstream. We have given birth to a range of new organisations to carry on work in those fields and others, including the Ethical Trading Initiative, AccountAbility, Time Banking UK, the London Rebuilding Society, the Community Development Finance Association and many others. We have also helped establish many others, including Jubilee Debt Campaign.

We have since gone on to launch big ideas like social return on investment, the green new deal, national accounts of well-being, and local money flow analysis. In many cases we have put our ideas in the hands of people who can use them as levers in their own local economies and neighbourhoods. We have also packaged the arguments, like the Clone Town Britain campaign and the Happy Planet Index in such a way that people are able to look at economic issues in new ways. No politicians or policy-makers had to defend themselves against the accusation that they were creating 'clone towns' until 2005 when we coined the phrase. They do now.

We have been at the heart of many coalitions and campaigns, including the 'Up in Smoke' group; 100 months; post bank campaign and the localism campaign.

nef is now playing a leading role in constructing a new economic model to guide policymaking in an era of ecological limits, having launching its New Economics Commission in October 2010.

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APPENDIX A - The case for a UK Community Reinvestment Act

A1 Introduction

We believe that by a UK Community Reinvestment Act (CRA) could stimulate greater choice and competition in the provision of banking services to both individuals and SMEs, particularly in disadvantaged areas. This would support the Commission's primary objective of competition, and we believe that by encouraging institutional diversity, in particular by supporting smaller, domestic, and quite tightly focussed community banks (Community Development Finance Institutions, or CDFI's) would also contribute to financial stability.

A2 Evolution of the US Community Reinvestment Act

The CRA has been in force in the US for over thirty years. From limited beginnings in the 1980s it has evolved, partly thanks to regulatory additions in the 1990s, into a uniquely powerful tool for making banks and other depository institutions socially accountable for exclusion from financial services.

There were three broad factors driving the phenomenon known as red-lining, meaning the wholesale exclusion of neighbourhoods by banks, in the US which led to the CRA: discrimination, poor credit evaluation and regulatory obstacles.

Though unwilling to venture into minority communities to open branches or lend, banks accepted those communities' deposits and savings. The 1961 Report on Housing by the US Commission on Civil Rights revealed the imposition of high down-payments and speeded-up repayment schedules for African-American borrowers, as well as blanket refusals to lend in particular areas.

However, discrimination was only one of the factors. As Ben Bernanke, Chairman of the US Federal Reserve, has pointed out, poorer borrowers were disadvantaged by the then rudimentary mortgage market and the barriers to accessing information easily about those types of customers. Credit evaluation was and remains relatively more expensive for lower income borrower groups, which was even more pronounced prior to the CRA[37].

Regulation added to the obstacles faced by poorer communities. Local and national rules inhibited banks from working across states; this restricted branches and reduced competition[38].

The CRA emerged out of a national campaign against discrimination in financial services, but subsequently evolved to address the causes and aftermath of a banking crisis; the Savings & Loan crisis of the late 1980s. The subsequent period was probably the most significant in the CRA's history. The crisis saw the bankruptcy of over 1500 deposit-taking institutions and galvanised reform. With the pro-active support of the Clinton administration, the number of CRA multi-year agreements between banks and local community groups to commit investment increased rapidly from $3 billion in 1993 to $43 billion in 1998. From 1993 to 1996 mortgage lending to low- and moderate-income communities in the USA rose by 38%[39]. A US Treasury review of the CRA found that banks and other financial institutions covered by the CRA made a total of $467 billion in mortgage loans to low- and moderate-income borrowers between 1993 and 1998. In addition small business lending in areas targeted by the CRA averaged $33 billion a year and community development investment averaged $17 billion a year[40].

A3 Did the CRA cause or exacerbate the subprime crisis?

In the United States and even in Britain[41] there has been a backlash against the CRA since the crisis with suggestions that it might have had a role to play. Yet, this seems to be unsupported. As Ben Bernanke has remarked:-

> *"The available evidence… does not lend support to the argument that CRA is to blame for causing the subprime loan crisis"*[42]

Testimony to the US Congress reveals that over half of subprime loans were not under CRA supervision but made by institutions not covered by its remit, and up to another 30% had limited supervision under the CRA as they were lent by subsidiaries of CRA-qualified banks[43]. A similar approach was behind HSBC's startling losses of £8.7 billion announced in 2009 from the loan book of its subprime lender subsidiary. HSBC had bought Household International Inc in 2003 for almost £10 billion. As ex-Federal Reserve Governor Ned Gramlich observed, the exclusion of independent mortgage companies from oversight by CRA and other regulations represented a "giant hole in the supervisory safety net" and, crucially, played a significant role in the crisis.

Though the CRA's effectiveness has been weakened considerably in recent years with the restructuring of the US finance industry, its benefits in the wake of the wave of sub-prime mortgage defaults remain striking. The overall rate of default for low-income, sub-prime borrowers with loans under CRA supervision was in line with the prime market. Evidence from the San Francisco Federal Reserve suggests that: -

> *"the CRA has increased the volume of responsible lending to low- and moderate-income households"*[44]

Studies of lending in US cities revealed that banks under the CRA were:

(i) significantly less likely than other lenders to make a high cost loan;

(ii) the average interest rate charged on high cost loans originating from CRA banks was lower than the equivalent from non-CRA lenders;

(iii) CRA banks were more than twice as likely as other lenders to retain originated loans in their portfolio, and;

(iv) foreclosure rates were lower areas with higher concentration of bank branches[45].

Common sense is probably the best support to this evidence. How could a 1977 law, or its 1990s amendments, drive the crisis that befell in 2007? In fact, the exclusion of many financial institutions from CRA oversight was part of a broader bonfire of regulation in the late 1990s and early years of 2000. The 2000 Commodities Futures Modernization Act defined commodities based on interest rates, currency prices and stock indexes as "excluded", meaning not subject to regulatory oversight. This set the stage for the doubling of the market in Collateralised Debt Obligations (CDOs) between 2001 and 2006, comprised principally of lending to poorer people that had avoided regulatory oversight.

A4 Is the CRA a relevant example to the UK?

In the United States, the definition of CDFI includes not just microfinance lending, but also credit unions, development banks and social venture capital funds. We believe that by learning from the US experience, the UK could stimulate greater choice and competition in the provision of banking services to both individuals and SMEs, particularly in disadvantaged areas where stimulating local economic growth is essential to the Government's stated aim of rebalancing the economy.

Between 1995 and 2003 the CDFI Fund, a public investment fund administered by the US Treasury, has provided over $800 million to all forms of Community Development Finance Institutions (CDFIs). The CDFI Fund is designed to build the capacity of CDFIs. It provides a basis for levering in greater private funding under the CRA. Banks can meet their CRA requirements by investing in CDFIs, in lieu of meeting the ratings requirements outlined under the Clinton-era CRA amendments. The Fund has succeeded in leveraging private investment that is twenty-seven times the value of public investment.

In the UK, attempts to catalyse the sector through the then Department of Trade and Industry's Phoenix Fund have leveraged-in far less investment despite tax incentives under Community Investment Tax Relief. According to the UK's Community Development Finance Association, the £181 million lent by UK CDFIs up to 2004 leveraged an additional £285 million. The Phoenix Fund itself provided less than £50 million in funds to the sector[46].

In the US, the higher level of public funding has enabled CDFIs to mature and ultimately free themselves of dependence on government support. Public funds allowed institutions to gain critical mass so that their own revenue and ability to raise matched private sector funding, including under the CRA, becomes their main source of funds[47]. In 2009 President Obama has included $400 million allocated to community development finance in the stimulus bill. This is not a bailout for struggling institutions. It is recognition of the stimulatory impact such institutions can have by supporting economic activity amongst groups that are otherwise economically disenfranchised.

What should be clear from the fact that the CRA did not prevent the subprime crisis is that the CRA is not a magic bullet. Abuses of vulnerable borrowers still occurred. Payday lending still grew to unprecedented scale, albeit in institutions not covered by the CRA. The CRA did not and cannot replace the need for ongoing prudential supervision and regulation of the entire banking and finance sector.

The UK financial sector is unlike the United States of the 1970s. Nevertheless, the lessons of the CRA are not limited to the need for Government intervention against discrimination such as that perpetrated by US banks three decades ago. They are evident in its ongoing impact. In its first decade the CRA was primarily a component of civil rights-era legislative reform that required disclosure. However, this disclosure permitted the counter-productive levels of exclusion to be exposed and eventually addressed by the 1990s amendments. CRA loans performed better in social and financial terms relative to those lenders outside of CRA supervision[48]. This was possible thanks to the CRA and other disclosure rules which reveal lending information and borrower characteristics, including race, income and credit score, enabling comparisons of loan quality between CRA and non-CRA institutions.

A5 Do we need a UK Reinvestment Act?

What problems of the UK financial sector could we expect a reinvestment act modelled on the CRA to address? Though attention focuses on the aftermath of the credit crunch, the efforts since the 2000 Social Investment Taskforce recommendations reveal that a crunch was occurring in certain segments of the economy far before the general financial crisis broke. Nevertheless the current crisis has brought these longstanding market failures into starker relief. **These include the decline in support and capacity for small enterprise lending from banks. A key motivation for the development of the CDFI sector was to build the potential of entrepreneurs who lacked tailored small-business support.**

The changes to the banking sector over the last three decades resulted in the high street banks' gradual abandonment of relationship lending and small business specialisation. As the Bank of England's quarterly trends in lending reports have shown, though the stock market and banks' share prices have recovered, credit to small and medium sized enterprise (SMEs) is still rationed and costly. The August 2008 report revealed that lending to all sectors had declined for the very first time and the lending levels had dropped to their lowest level since the height of the crisis[49]. Efforts by Government to target support to SMEs have had questionable success, for example by replacing the Small Firms Loan Guarantee with the Enterprise Finance Guarantee which has been beset by reports that banks are not using it effectively[50].

The impact of personal financial exclusion, affecting between 900,000 and 1.75m people in the UK according to Treasury figures, is well documented. Essential services become more expensive, for example by paying for utilities without direct debit, and moments of financial difficulty drive people to predatory and very expensive credit. The efforts of credit unions and the community finance sector demonstrate that more support and appropriate finance can benefit both the excluded and their communities. A UK reinvestment act that empowered such institutions and obliged the mainstream sector to support their work via investment and disclosure of their own lending patterns would be a dramatic step forward in dealing with this corrosive form of deprivation.

There are three principle lessons of the CRA that can be distilled from its current operation and its historical evolution.

Lesson One: Transparency

The requirements for disclosure enshrined in the CRA and the legislation that accompanied its inception are its foundation stone. Disclosure enables the tackling of exclusion by targeting stimulation of economic activity amongst people and communities who would not otherwise participate in the wider economy. This goal is also beneficial to the stability of the financial system. It is now abundantly clear that avoiding future crises will require far greater openness from the banking sector regarding their lending and investment positions, of which CRA-style disclosure conditions should be a component.

Lesson Two: Fairness

The CRA's history is about the growth of appropriate finance, particularly in the 1990s. The post-crisis critics who accuse the CRA, wrongly, of having forced good credit to be lent to bad risks presume the provision of any finance to higher-risk groups to be potentially toxic. The evidence from the subprime crisis suggests that appropriate finance, supervised by the CRA, has been enabling and even protective of people's livelihoods and homes. Indeed, the consequences of not regulating and supervising this market closely enough, including the financial institutions themselves, are now all too evident.

Lesson Three: Partnership

The tenets of fairness and transparency, and the rules to realise those principles, create the basis for the most startling aspect of the CRA's success. Disclosure of lending and incentives to engage with communities and social finance institutions within them leads banks to invest as partners in the communities where they operate. The US community finance sector has now grown to well in excess of $8 billion[51]. Instead of seeing the regulation and oversight required by the CRA as simply onerous, many US banks promote their long history of engagement and celebrate when awarded high CRA ratings as a vindication of their community approach and brand[52].

A6 Designing a UK CRA

What should be the essential principles and features of a UK Reinvestment Act?

Disclosure

The basis for making a disclosure requirement obligatory has not changed since the recommendation was made in the 2000 Social Investment Taskforce report[53]. **nef** subsequently documented in its 2006 report Full disclosure: why bank transparency matters that banks have failed voluntarily to achieve the level of disclosure required[54]. The original Taskforce report notes that if voluntary mechanisms did not succeed then the sector would need obligatory rules. To make this disclosure effective it needs to ensure that qualitative information about borrower characteristics, such as income levels, is matched with geographical information down to ward level. The Bank of England is ideally placed to gather and publish such data in a manner designed to guide policy targeting exclusion, as it would ensure that all data was comparable and allay concerns from banks about revealing sensitive corporate information, and could do so in line with its quarterly lending reports.

Rating Banks' Social and Financial Performance

The US CRA operates a ratings system to incorporate both the measurable quantitative performance of banks' vis-à-vis serving their communities, which guides regulatory decisions. The ratings system is also a form of incentive, which transforms the disclosure requirements from onerous duties to mechanisms by which institutions can demonstrate their social and economic commitment. A matrix to provide a basis for both quantitative and qualitative assessment of banks' performance needs to be developed to rate banks. This should be based not only on financial parameters but on associated social factors, such as branch presence, disclosure, take-up of Basic Bank Accounts, assessment of lending affordability and appropriateness; it should also consider levels of support to local and regional social finance. This could include CDFIs, Credit Unions but also support to innovative financing mechanisms, including Industrial and Provident Societies' share issues and Community Land Trusts.

Regulatory Objectives

The Financial Services Authority (FSA) has come in for stinging criticism during the financial crisis. US law directs regulators to use their authority to encourage insured depositary institutions to help meet the credit needs of their local communities, and that lending activities be consistent with safe and sound operation. Yet accusations of the FSA having been lax in its oversight should be considered in light of the conflicted role the FSA has had to play. While regulating the financial sector, it has been tasked with statutory objectives to build public awareness of the financial system and ensure market confidence. We note that proposals for reform of the UKs regulatory structure are currently under consultation.

A reinvestment mechanism

Discussions of reform of the financial sector range from advocating a return to business as usual as quick as possible with some restraints on excessive lending, to a wholesale change to business models, accounting rules and regulation. The goal of any UK reinvestment act should not be too broad: it has a specific purpose, but is not a magic bullet that can stand-in to correct all aspects of banking failure. Legitimate debate is occurring about reform to social investment policy, such as of Community Investment Tax Relief or whether to place a cap on interest rates to prevent usury. Rather than addressing 'all of the above', the opportunity for a reinvestment mechanism needs to be focused on benefiting the economy via a constructive partnership between banks, alternative finance providers and the wider economy.

In summary, the basis of the design of a UK CRA should be constructive partnership between social providers and banks - a mechanism which requires banks to reinvest in social finance that targets the parts of the economy that mainstream banking does not reach. This might be a levy on the sector that is determined by banks' performance and that can be offset against direct investment. This investment could be either via support to a permanent fund, rather than the temporary efforts of the Government's short-lived Phoenix Fund, or directly into CDFIs, credit unions or other social finance structures.

A7 Conclusions

The lesson of the US CRA for UK policy is that the need to address our current financial structure's inability to resolve financial and social exclusion among individuals and small enterprises need not be framed as a conflict. It is not a question of striking a balance between the benefits of a free and competitive banking system versus addressing the unintended consequences of that freedom and competition. **In the reinvestment model, banks and wider society have the basis for a constructive relationship that can represent a new settlement with the banking system that helps to usher in growth in social finance as a complement to the banking sector in a partnership that harnesses the potential benefits of both**.

APPENDIX B – Some relevant previous publications from nef

Where did our money go? Building a banking system fit for purpose (Oct 2010)

In 2008, the Government issued the biggest single public bail-out in history to rescue major retail banks in the middle of a credit crisis. This report asks where our money went, who has benefited from it, and what was asked of the banks in return.

Better Banking (April 2010)

A manifesto to re-organise the UK banking system to serve and strengthen the British economy through structural reform.

Doorstep Robbery (Nov 2009)

The very poorest people in the UK are paying thousands of pounds to legal loans sharks who charge them over the odds for something that most of us can easily access at the bank: credit. This report calls for immediate Government action to curb high-cost predatory lending.

The Ecology of Finance (Nov 2009)

The financial system needs to start working like a productive ecosystem. It should be characterised by diversity and an ability to sustain specialised and adapted life in the face of external shocks. Instead of a monoculture of mega-banks deemed too big to fail and answerable only to the demands of private shareholders, an ecology of finance would involve a range of different financial institutions.

The Case for a Post Bank (Mar 2009)

A proposal for a publically-owned bank based at the Post Office network which would provide reliable financial products to small businesses and promote financial inclusion.

I.O.U.K. (Mar 2009)

A call for a radical new approach to banking and finance beyond 'business as usual'. The report challenges the idea that bigger is always better and makes the case for the supporting community finance institutions.

Credit with a social mission (Dec 2008)

This briefing argues for the urgent alignment of microlending in the UK with the microfinance movement to improve the sector’s standing, and to recognise its social benefits to society.

From the Ashes of the Crash (Nov 2008)

Having predicted the current crisis in the global economic system back in 2003, **nef** offers twenty proposals both to stabilise the economy and lay the foundations for a new economic order.

Social investment for community development (Sep 2008)

This report identifies five clear steps required to complete the infrastructure for a thriving social investment market in the UK, and calls on the government to act.

UK CDFIs – from surviving to thriving (Sep 2008)

This report examines the extent to which the community finance movement is fulfilling its original purpose to provide affordable finance to disadvantaged communities. The authors determine this by analysing the experience of four case study organisations. They also consider this question in the context of the varying demands being placed on CDFIs by both policy-makers and funders.

A Green New Deal (Jul 2008)

The global economy is facing a ‘triple crunch’: a combination of a credit-fuelled financial crisis, accelerating climate change and soaring energy prices underpinned by encroaching peak oil. It is increasingly clear that these three overlapping events threaten to develop into a perfect storm, the like of which has not been seen since the Great Depression, with potentially devastating consequences.

Self-help and mutual aid: re-thinking microfinance (Jun 2008)

Self-employment in the UK has doubled over the past 30 years. Support for the self-employed is vital for a healthy economy. This report explores ways of supporting sole traders through microfinance.

Going green? (Sep 2007)

How effectively is the financial services industry is catering to the ever-increasing demand for ethical financial services?

Reconsidering UK Community Development Finance (Jun 2007)

The first comprehensive assessment of the work of CDFIs - Community Development Finance Institutions - in the UK, examining their role in tackling financial exclusion and economic disadvantage, and helping support enterprise.

Full Disclosure (Dec 2006)

UK banks could be doing much more to help some of the poorest people in the UK, simply by being clear and open about where they do business.

Developing a social equity capital market (Nov 2006)

Social enterprises need a different kind of equity market to suit their needs and stick to their values. This report examines some of the new mechanisms for investment which could bring this about.

ENDNOTES

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[20] An oligopolistic market is one where a handful of firms have control or extensive influence, enabling them to impose worse services or higher prices on buyers. A well-known example of this is the OPEC cartel of petroleum exporters.
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