Is UK Banking Better?

by

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1) Introduction

This paper reports the deliberations of a panel of three speakers which met on 12 June 2014, 12.00-18.00 in Bournemouth University Business School's Executive Business Centre (EBC) as part of BU's annual Festival of Learning to discuss the topic: "Have We Made Banking Good?"

The event was aimed at a general and audience and organised and Chaired by Andy Mullineux (Professor of Financial Economics and Deputy Dean Research in the Business School) relating to BU's "Enterprise and Economic Growth" Research Theme (www.bournemouth.ac.uk/fol).

The panellists were: Kate Elliot (Investment Management Services, Rathbones, Liverpool), Ed Mayo (Secretary General, Co-operatives UK) and Richard Werner (Professor of International Banking, Business School, University of Southampton). Kate had written a report for the Ecumenical Council for Corporate Responsibility (ECCR) which was launched in Birmingham in November 2011 and entitled: "Restoring Trust in Banks". Andy had been a panellist discussing the report and subsequently joined the West Midlands ECCR committee Chaired by the Right Reverend David Urquhart, Bishop of Birmingham; which met with representatives of UK banks to consider how trust in them might indeed be restored. The deliberation of the West Midlands ECCR informed Kate's follow-up report entitled: "The Banks and Society: Trust Rebuilt?" It was launched at Rathbones in Liverpool in March 2014 and formed the basis of her panel presentation.

Ed Mayo heads the trade association of Co-operatives in the UK, which includes credit unions. It had been an eventful year for the Co-operative movement following the findings by the Bank of England in 2013 that the Co-operative

Bank Plc was undercapitalised and the consequent need for the Co-operative Group to inject capital and bring in a large amount of private capital to shore it up. The contrast with the continuing success of the John Lewis Partnership, the employee-owned cooperative in the retail sector, was stark. Ed and Andy had worked together on the Joseph Rowntree Foundation Report entitled: "Small is Bankable" in 1998. That report advocated the development of Community Development Finance Institutions (CDFIs) as an alternative source of funding for smaller enterprises. More recently Andy and Ed have worked on a Blog for Co-operatives UK on the "Future of Mutual Banking in the UK", which will form part of a book entitled: "Co-operative Advantage, to be launched in 2015".

Richard Werner had recently launched the Hampshire Community Bank, a mutual bank, with the backing of Eastleigh County Council and funding for lending to small enterprises from the UK government Department of Business, Information and Skills (BIS). Andy was engaged by Eastleigh County Council to serve as an advisor on the project proposal.

The panellists were clearly well placed to discuss whether or not banks had been made good as a result of post crisis regulatory reforms, or at least been made better and more trustworthy.

2. The Panel Discussion

Speaking first, Kate noted that there was no black or white answer to whether trust in banks had been built; the answer was rather a shade of grey! She had started work on the first ECCR Report in 2009, which had focussed on social and environmental issues, and started the follow-up report in 2013. Lots of issues covered in the 2011 report remained pertinent in 2013/14, whilst social justice issues relating to bank taxation had been added as an important issue.

The 2014 Report found that trust in banks had not yet been rebuilt, although considerable transformation was underway with the aim of rebuilding trust in the banking industry and the answer may be to encourage diversity in the banking sector. Kate drew a distinction between trust and confidence. At the start of the crisis, in August 2007, banks lost trust in each other; as manifested by the collapse of their willingness to lend to other banks through the interbank market. Governments and Central Banks then intervened in an attempt to maintain confidence in the stability of banking systems, but trust in individual banks was eroded. Kate noted that since the crisis banks had continued to undermine trust through a series of miss-selling scandals, such as Payment Protection Insurance (PPI), and the LIBOR and exchange rate market price rigging scandals.

Despite these backward steps, with the help of the regulatory and structural reforms advocated in the Vicker's (Final) Report in September 2011 and the Parliamentary Committee on Banking Standards (PCBS) (Final) Report in November 2013, as incorporated in the Financial Services (Banking Reform) Act in December 2014, and subject to amendments in April 2014., some forward steps had been taken and some **good noises** sounded, Kate concluded.

The 2014 Report was based on meeting with the six major UK banks, including Santander. The banks had sent higher ranking staff to these meetings than they had to those informing the 2011 Report and thus seemed to take the exercise more seriously. The West Midlands group fed into the 2014 Report, but had felt that the banks representatives that attended their meetings were more representative of corporate social responsibility (CSR) than operational activities at their banks. Kate's interviews with the more senior bankers revealed that they were seemingly trying to embed better values and improve compliance, and the recent Lloyds CSR report had contained forward looking statements consistent with this.

As regards regional lending, the British Banking Association had recently published postal-code related lending data, but the reporting was somewhat granular and more transparency would be desirable. More detailed information on executive remuneration and appropriate rewards for genuine success, rather than failure and 'talent' would also help to restore trust, Kate felt.

As chair, Andy observed that at a Centre for Responsible Credit (CfRC) conference in London 2010 Reverend Jessie Jackson, a prominent US Community activist, had advocated that bank customers should buy a share in their bank to entitle them to attend its Annual General Meeting and make a noise by asking challenging questions.

Whilst researching in Chicago for the 'Small is Bankable' Rowntree Report in 1997, Andy had met Gale Cincotta, a community activist who had explained that the US Community Reinvestment Act was important not so much because it required banks to lend into communities from which they took deposits, but because it required them to provide information by zip (postal) code on where they gathered their deposits and how much they re-invested in those communities. This information had empowered community activists such as Gale to lobby the banks.

Ed Mayo spoke next and related three stories to illustrate the potentiality of community oriented mutual banking. The first story, it so happens, involved Gale Cincotta and her role in identifying the 'red lining' by banks of neighbourhoods that was followed by branch closures leading because some communities had come to be regarded as 'unbankable', at least as regards bank lending. The affected communities were often African-American ghettos and so the 'red lining', a term borrowed by the insurance industry, was tantamount to racism. It prompted the US government to intervene, first through the Home Mortgage Disclosure Act (1975) in response to the disproportionately high rate of decline by banks of applications for mortgages by Hispanics, and then the Community Reinvestment Act (1977), which was enhanced by the Clinton administration in 1995.

The CRA required banks to serve the credit needs of communities from which they took deposits – an 'affirmative obligation'. Compliance was encouraged in the late 1990s on banks sought to exploit opportunities provided by deregulation under the Gramm-Leach-Bliley Act (1999) to gain permission to diversify into investment banking. CDFIs were adopted by the bigger banks on vehicles to facilitate the required re-investment and grew in importance as a result.

In the chair, Andy noted that budding activists in the audience might consider joining the 'Move your Money' campaign in the UK, especially now that banks have been required to make it easy for customers to transfer their Standing Orders and Direct Debits, and thus their current accounts, to another bank.

Andy also recalled the fictitious character George Bailey, played by James Stewart in the favourite US Christmas movie: "It's a Wonderful Life" (1946). George Bailey ran the town's Housing and Loan Association, which funded on affordable housing programme. The town's rival shareholder-owned bank unsuccessfully tried to undermine George and the Housing and Loan Association in order to make way for commercial housing and other property development projects in the town.

This raised the question: 'what sort of banks do we really want'? As Kate had remarked, diversity in bank ownership structures, including mutual and shareholder models, should perhaps be promoted as different models may serve different needs. In the US and Germany, relatively small local mutual banks serve households and Small and Medium Enterprise (SME) needs, whilst larger, shareholder-owned banks serve larger companies and corporations.

Ed's second story related to the first Credit Union in England, which was set up within days of Ed's birth in Wimbledon, well before the 1979 Credit Unions Act. It was established by people from the West Indies based on the CUs that had been formed in the British and Dutch Carribbean. The first was in Jamaica in 1942, where a Boston-based, Irish-born Jesuit preist, Father John Sullivan, lead the project more than 15 years before the first credit union was started in Ireland; where they were introduced by women. CUs in the USA also have a much longer tradition than in England.. The largest CUs tend to be work-based, often benefiting from sponsorship providing back-office operations and premises as worker benefits. Smaller, more community based, CUs tend to have to rely on voluntary workers and use community meeting places to contain costs. The Right Reverend Justin Welby, Archbishop of Canterbury, is promoting CUs as an alternative to high cost 'payday' lenders and making church premises available to help subsidise their operation. In addition, the government, through the BIS has provided £30m to fund a CU development programme which the Unity Trust Bank is helping to disburse. But, is too much is being expected by the CUs, and are they really suited, as mutual banks, to serving the subprime lending market?

The Woodstock Institute in the Chicago has found that CUs tend to serve the blue collar workers and the lower middle classes, rather than focus on poverty alleviation as its director at the time, Malcom Bush, explained to Andy during his research for 'Small and Bankable'. With 'payday' lending rates now capped by the Financial Conduct Authority in the UK, an exodus from the payday lending business is underway. Doorstep lenders, pawn brokers and other 'loan sharks' seem more likely to fill the void than CUs, Andy observed.

Ed's third story recalled the origins of the UK Building Society movement. Richard Ketley, the landlord of the Golden Cross public house in Birmingham in 1775 devised a mutual self-help scheme for home building for Irish 'navies' working on the building of Birmingham's canals, which are more extensive, reputedly, than those of Venice!. The Irish workers were largely homeless and so Richard Ketley, magnanimously encouraged them to put some of their money in a beer glass, rather than spend it all on beer. When enough savings were accumulated, the first house was built, and they kept saving until all the contributors had a house and the building society was closed. The idea spread and perpetual building societies developed. The largest surviving one today, for those that demutualised to become mortgage banks all failed or were absorbed into larger banks in the financial crisis 2007-09, is Nationwide, a prominent member of Co-ops UK.

Co-ops UK has around 6000 members; many of them in the financial sector, including CDFIs, and CUs, who are represented by ABCUL involving over 1 million **members in Great Britain**. Big banks however control the payments system and dominate retail banking service provision to households and SMEs, making it difficult for smaller 'Challenger' banks, including those set up by big retailers such as Tesco and Sainsbury's, to penetrate the market in a significant way. As a result, subsequent to the Festival of Learning, in July 2014, the UKs Competition and Markets Authority announced that it proposed to undertake a full review of retail banking product and service provision. Ed also drew attention to the City of London's traditional focus on the international finance system, rather than financing UK regional development.

Ed next drew lessons from the recent experience of the UK's Cooperative Bank, which was not a mutual in the sense of being owned by its depositors and borrowers like a building society, but was owned by the Cooperative Group and had been allowed to overstretch itself by taking over the Britannia Building Society in **date** to form a 'super-mutual' and thus a potential challenger to the public shareholder-owned banks. Britannia had been active in 'buy to let' mortgage lending, a non-core business that suffered from rising bad loan levels following the collapse of the house price bubble in 2008/9.

The Coop Group commissioned a report on 30th April 2014 by Sir Christopher Kelly (the 'Kelly Review') entitled: "Failings in Management and Governance - An independent review of the Cooperative Bank". The £1.5bn capital shortfall discovered by the Bank of England was largely caused by the failure to conserve capital and instead to pursue the ill-advised purchase of Britannia Building Society as a result of failed oversight by the Banking Group Board of the bank's executive. Subsequently Lord Myers, who had chaired previously chaired a committee on corporate governance and served as 'City minister', was brought on to the Board to advise on improving its structure to facilitate better and more professional governance. His recommendations in have largely been accepted, though in August 2014 the decision was taken by the new executive to include some direct member representation from the co-operative movement, which Lord Myers had counselled against. The Cooperative Bank has now effectively been completely demutualised, with the Co-operative Group retaining a non-controlling 8% share, and subsequent calls by the Bank of England for further increases in its capital seems likely to see the Group further reduce its shareholding.

The building society demutualisation that followed the 1986 Building Societies Act involved 'carpet baggers' lodging deposits, and thus becoming shareholders, in targeted societies and then forcing a vote. The Nationwide staunched the process by adopting a structure that enabled a vote against de-mutualisation, although Kent Alliance was moving away from owner-control, and the International Cooperative Alliance was helping to instate structures that could block demutualisation.

The way forward for new mutual banks, including CUs, may be to copy the German model under which cooperative and local authority backed savings banks (Sparkassen) share back office services provided by national and regional institutions that they own and engage in mutual self-regulation. The Desjardins group in Canada provide another model of secondary co-operation and self-regulation..

The Basel Committee led post crisis increases in bank capital and liquidity requirements are designed to make highly leveraged shareholder-owned banks less likely to require taxpayer bail-outs in future These, and other new regulatory requirements have the potential to make public sector and mutual savings banks unviable, and thus to reduce diversity in banking, as the European and World Savings Bank Institutes are making clear.

Finally, Ed discussed innovations that might help mutualised local community banking to thrive. Internet-based 'crowd funding' and 'peer-to-peer' lending offered the opportunity for funding local commercial and social enterprises and Co-ops UK with Locality is a pioneer in this field through its community-shares programme, including the microgenius platform.. In mainland Europe co-operative or mutual guarantees are widely used by small businesses to support each other and attract bank lending, but this practice is yet to take root in the UK. Other related models include group borrowing by the Confidi in Italy. Such schemes cover approximately 8% of SME funding in the rest of the EU.

Promoting Access to finance for SMEs is the issue of the day in the UK and the EU. Simply urging banks to do more won't work, but conditional cheap funding, such as the UK's Funding for Lending Scheme (FLS) and the ECB's Targeted Long Term Refinancing Operations (TLTRO) scheme modelled on FLS, combined with appropriate government backed loan guarantee programmes, such as those provided by German development bank (KfW), may help, Andy observed.

To survive and thrive, mutual and public savings banks will need to be regulated differently from the big shareholder-owned banks. This is appropriate because savings banks have more stable retail deposit based funding, and thus little reliance on wholesale interbank funding, in contrast to the big commercial banks. They are net providers of wholesale deposits to larger banks, and engage primarily in collateralised lending, particularly as mortgage loan providers. The new EU Single Supervisory Mechanism (SSM), which comes into effect from November 2014 allows smaller local banks to be nationally regulated, initially at least, whilst the bigger cross border banks are to be supervised by the European Central Bank and regulated by the European Banking Authority.

The third and final speaker was Professor Richard Werner, who asked at the outset whether we could in fact have good banks and what, indeed, was the purpose of banks? He questioned the assertion that the 'interest rate cycle' drove the business cycle, for which there was no empirical evidence, indeed rather the reverse. Instead, interest rates lag, or follow, economic fluctuations in the short run and thus fluctuations in growth drove fluctuations in interest rates, rather than the reverse. This is because interest rates are the price of money, and rationing of the supply of money, which is overwhelmingly the result of commercial bank credit creation, rather than central bank money issuance, is prevalent. It is the quantity of money created, relative to the demand, that determines its price. The demand for money is relatively static, so it is the extent of rationing by banks in accordance with the 'short-side price principle', and thus the 'economic rent' extracted, that determines its price (interest rates). The banks determine the supply of money and have been licensed to do so by governments through their monetary authorities. Money is a 'public good', but its production has been privatised; allowing credit rationing, whilst avoiding usury rates for all except the 'financially excluded'. The more concentrated banking systems are allowed by governments to become, the greater the credit rationing and inequality in access to finance.

The expansion of debt that results for money supply expansion can lead to a 'growth imperative', where growth has to continue or even accelerate, regardless of environmental degradation, in order to facilitate the servicing of accumulating debt. To break this adverse spiral, lending by banks needs to be productive, rather than wastefully funding consumption and speculation, Richard argued.

In the UK, 95% of retail banking is conducted by the big banks, whilst in Germany, 70% is conducted by local banks. The newly created Hampshire Community Bank aims to be the first in a network of local banks serving the Southern region, with the proposed Bournemouth Bank hopefully joining it soon. The Hampshire Community Bank is a 'not for profit' entity owned by a charitable trust and is modelled on German Sparkassen banks. It is hoped it can initially tap into their back office network services until shared back office arrangements can be established, perhaps with the Bournemouth and other local community banks in the future.

In the US and the EU, big banks tend to serve large firms whilst smaller banks serve smaller firms, including SMEs. The UK faces a particular problem because 'The City' tends to extract capital from the regions in order to finance developments in London or overseas.

The Hampshire Community Bank has applied for a banking licence to enable it to leverage its £10m start-up capital into £200m worth of lending. It will be a local bank for local people and local businesses and thus a true community oriented bank.

Andy recalled that he had written an Anglo-German Foundation Report with Dr. Eva Terberger (University of Heidelberg), entitled: "The British Banking System: A Good Role Model for Germany?'. It was published in2006, a year before the crisis. At the time, the three (now two, following the absorption of the failing Dresdner Bank by Commerzbank during the Great (or 'Global') Financial Crisis, GFC) shareholder-owned banks in Germany were lobbying the German and EU authorities to be allowed to take over German savings banks in order to 'rationalise' the German banking system. Their argument was that increased concentration in the bank industry would make it more cost efficient and better able to compete with the highly concentrated UK banking sector. We concluded that this would not be in the interests of households and SMEs, or indeed the German Mittelstand companies and the economy as a whole. Frankfurt's goal of competing successfully with London as an international, or the European, financial centre was not worth sacrificing the retail savings bank sector that had served local communities so well, and indeed continued to do so, for.

3. Questions and Answers Session

In the Q&A session that followed the panel's deliberations, the question of whether banks should lend for non-productive house purchases, as opposed to just for productive house-building, was posed.

There was also discussion of the role of the investment banking culture inculcated by Bob Diamond as CEO of Barclays, a bank set up and run for many years by Quakers. Would the new CEO, Anthony Jenkins, lead it back to its retail and commercial banks roots by scaling back its investment banking operations?

It was commented that restoration of trust had both an ethical dimension and a need to re-assure on technical competence and that the GFC had been the result of inadequate risk management and the under-pricing of risks.

It was noted that retail banking is not just about selling products, which through inappropriate bonus structures can lead to miss-selling, as in the PPI debacle, but also about banks serving customers, treating them fairly and 'relationship banking'. In their report, Andy and Eva Terberger had argued that local banking was successful because it was based on 'relationship banking', rather than centralised computer-based lending techniques based on 'credit scoring'.

Ed pointed out that it is the composition of ownership that sets the principles. A Quaker family had given Barclays its sense of purpose, or mission. The Co-operative Bank had developed a set of ethical lending principles from 1992, and these have been retained in its mission by its new non-mutual owners.

4. Concluding remarks by the Chair

On 19 May, prior to this Festival of Learning panel event, the 'Banking Standards Review: final report' or 'Lambert Review' was published. Sir Richard Lambert had been asked by the Chairman of the UK's six biggest banks and Nationwide, its biggest building society, to design an independent organisation with the aim of promoting high standards in banking.

The establishment of a Banking Standards Review Council (BSRC) was recommended. It was hoped that the BSRC would "contribute to a continuous improvement in the behaviour and standards of banks and building societies doing business in the UK". The initiative was welcomed by the commissioning Chairmen and the Governor of the Bank of England, Mark Carney.

It was proposed that the BSRC be funded by, but remain independent from, the banks. If it succeeds in raising standards of behaviour and competence in the in the banking sector, and banks successfully improve their governance structures and internal risk controls, and also avoid further damaging scandals and consequent fines, then trust should progressively be restored.

Banks and banking should become better at serving the public, or common, good, and thus local communities, as well as shareholders. To do so, bonus structures will need to be appropriately aligned to assure customers are treated fairly, lending is undertaken responsibly, and access to appropriate and affordable financial services is assured. Something akin to a 'universal service obligation', commonly employed for utilities, is required to avoid financial exclusion through credit rationing.

A UK, or better EU, version of the US Community Reinvestment Act might be contemplated, but essentially the retail banking sector should be regulated as a utility given that the payments system is infrastructural and money (or credit) is arguably a 'public good', and so is financial stability. To the extent that regulation and supervision and economics of scale, and perhaps scope, require competition to be restricted and require bigness in banking, the case for regulating retail banking, like energy the energy sector, as a utility is even more compelling. The increasing adoption of internet and mobile phone based financial services is, however, challenging the alleged scale benefits form bigness in banking.

References to be added, if appropriate.