



Banking for the Common Good

Laying the foundations of safe, sustainable,
stakeholder banking in Scotland

A discussion paper by:



COMMON WEAL



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Executive Summary

Scotland's banking system is unstable and unfit for purpose. In 2008, led by Scotland's RBS, the UK banking system collapsed and formerly private banks required £1,162 billion of support from the UK Government. The crisis cost the UK economy as a whole up to £7,400 billion.

Eight years have passed since the crisis and our banking system is broadly unchanged. Scotland has an extremely highly concentrated banking sector and Scotland's banks are not providing the services required by people or business. UK-wide 2 million people do not have a bank account and there are now 1,500 communities with no access to banking. Evidence suggests that the poorest are the most likely to lack access. Small businesses are neglected, and what lending is available is disproportionately focused outside of Scotland.

Our banks are not providing sufficient funds for much-needed infrastructure. Our banking system is structurally unable to fund "patient capital", i.e. low-return but potentially risky investments, like those which are needed to stimulate the transition to a low-carbon, sustainable economy. Instead, billions are channelled into property, inflating asset prices, as well as unsustainable industries such as coal mining, the manufacture of nuclear weapons, and speculation on food prices, a practice which is fuelling global malnutrition.

Alternative institutions exist but are small and struggling to compete in a system set up to privilege the big banks. Payments systems, which facilitate the electronic exchange of funds, are controlled by the biggest banks, which have a vested interest in excluding entrants. London based Metro Bank is the only new high-street bank to open in the UK in 150 years. Small regulatory changes have not rebalanced our finance sector or repurposed finance to serve the needs of society.

We need more diversity in our financial institutions. Other developed economies have a range of institutions which provide stability and public accountability.

National investment banks provide strategic and long-term finance to industry either directly or through intermediaries. Examples include Germany's Kreditanstalt für Wiederaufbau, the European Investment Bank and the Nordic Investment Bank. The existence of national investment banks or other forms of public ownership of banking is closely associated with higher economic growth and greater economic stability. Studies of Germany, China and Russia have also evidenced that public banks are more efficient than private banks. Structured at arms-length national investment banks do not incur additional

public sector debt and can be used to leverage tightened government infrastructure budgets.

Most developed countries also have some form of local and regional banking, owned and capitalised by local government or local investors, and focused on investing within a specific geographic area. US credit unions fulfil this role, where 47% of the population are members of a credit union. Switzerland's cantonal banks and the Germany's local Sparkassen banks are major providers of current accounts.

Whilst retaining their independence, local banks in Germany also cooperate regionally to gain economies of scale for shared services such as payment systems and marketing. Stakeholder banks such as these lend counter-cyclically and, not beholden to maximising profit, invest patiently. In 2012 Germany's local banks provided 45% of long-term business lending.

In 2013 the Scottish Government said it would seek to "fully repair... the appropriate relationship between the banks and the society in which they operate" insisting "where the Scottish Government can act, it will." We believe Scotland's banking system should build on the best practice from around the world. We suggest a new model is necessary to provide banking for the common good.

Not-for-profit "People's Banks" should be established in Scotland's regions to offer banking services to local people and business. They would be overseen by representatives of local people and bank workers with support from financial experts, and be capitalised by national investment bodies and local authorities. By investing solely in their respective regions, People's Banks would help money circulate within local areas and serve the public interest.

Local banks would be part of a "People's Banking Network" to share risk and cooperate on training, marketing and the operation of key services such as payments systems.

A "Scottish National Investment Bank" would help establish these institutions by offering seed funding and structural support. The bank would be institutionally independent from Government but publicly owned, and mandated to promote through its lending sustainable development and employment.

A national investment bank would leverage Scotland's existing infrastructure budget to invest in projects which private banks are unwilling or unable to fund. We argue that with only a modest 6.5% (£225 million) of the Scottish Government's capital budget invested as subscribed capital this new bank would leverage a total of £3.4 billion to invest from year one. Scotland's local government pension funds, valued at £28 billion, could invest in bonds

issued by such a bank, giving them a reliable mechanism through which to invest in local infrastructure.

Our analysis focuses on Scottish banking. Scotland is part of the Sterling area and just as this analysis is applicable across the UK, so are our proposals. However in the absence of a response from the UK Government we believe that with vision and political will the Scottish Government can implement these reforms directly.

Our recommendations are:

1. Scotland's political parties should discuss and endorse the implementation of our model for banking for the common good.
2. The Scottish Government should convene a taskforce to examine these proposals in greater depth, bringing in a wide range of stakeholders to include Scottish Enterprise, economic development agencies, existing local and municipal banking institutions, credit unions, civil society groups and local authorities.
3. The taskforce should commission legal and regulatory advice on how a Scottish National Investment Bank could be created, to underpin the creation of a People's Banking Network for local, democratic banking in Scotland.

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Introduction

Our banking system is still in dire need of reform.

It isn't delivering sufficient productive investment to meet the needs of the economy and is failing to fund the transition to a sustainable economy. It doesn't offer a good deal for customers on the high street or for small businesses. Competition is stifled, and the sector seems to be locked into a cycle of fines, bailouts and crisis.

Many other countries offer better examples of banking and bank regulation. There is much to be gained by learning from their collective experience, but for us to make the shift away from the current extremes of concentration of ownership and light regulation will require vision and political will.

In 2013 the Scottish Government published 'Sustainable Responsible Banking' in which it set out a strategy to "fully repair...the appropriate relationship between the banks and the society in which they operate", insisting "where the Scottish Government can act, it will"¹.

70% of small business banking is controlled by just two banks, RBS and Lloyds², and the years since the Scottish Government's strategy was published have seen crisis and closure for several of Scotland's local and municipal banks. Ineffective UK reforms have been further curtailed, and there is much talk of yet another looming systemic crisis.

However, in this report we will show that if our governments have failed to reform banking it is not because finance is beyond reproach.

There are countries with banking sectors that provide a more positive role in the economy. There are even countries where banking is pro-actively socially and ecologically useful – financing home insulation, renewable energy and social housing.

In many countries banking systems are composed of an ecosystem of local and national institutions, democratically owned, controlled and accountable, investing in local productive economies.

Our current financial system, dominated by a small number of very large shareholder-owned banks focused on short-term returns, is the odd one out. All we are proposing is

¹ The Scottish Government, 'Sustainable Responsible Banking' (2013) Available at:

<http://www.gov.scot/Resource/0042/00422011.pdf>

² The Scottish Government, 'Sustainable Responsible Banking' (2013) Available at:

<http://www.gov.scot/Resource/0042/00422011.pdf>

reason. A banking system that is socially useful is not fantasy, and here's how we can build it here in Scotland.

Our approach to banking reform

This paper will show how the Scottish Government could create a model banking system, made up of local, democratic banks underpinned by publicly-owned infrastructure and a national investment bank generating wealth.

We begin by mapping our current banking system and how it is falling short; in the second section we summarise years of research into alternative banking models to show what a better banking system should look like; we then proceed to show how the Scottish banking system can be transformed to better address the needs of society, the economy and the environment. The report concludes calling for the Scottish Government and other institutions like Scottish Enterprise to set up a task-force to investigate these proposals in detail.

This paper outlines some key steps: the creation of a Scottish Investment Bank; methods of capitalising it; the creation of a publicly-owned banking payment system; and the creation of *People's Banks*. These would create an environment within which a new, locally-based and more accountable banking infrastructure can grow.

Scotland inhabits a monetary union, and reform of the Sterling area requires action using powers which lie with the UK government and the Bank of England. Our critique of banking in Scotland can be applied across the UK, and reform should come from the UK government. However, in the absence of a response from the UK Government, we believe the Scottish Government must take the lead and do what it can with its existing powers, and we think it can do a considerable amount.

This is not a blueprint, it is a proposal regarding ambition and direction of travel.

Side note: the story of RBS

The story of RBS is the story of Scottish banking, and it does not make for pretty reading. Headquartered in Edinburgh since it was chartered in 1727, it was once renowned as stoic and dependable, but is now a pin-up for casino capitalism.

The 2008 financial crash saw the bank hideously exposed, with annual losses of £28 billion³ – the biggest ever in UK corporate history. RBS became 70% (rising to 78%) owned by the UK Government after a record-smashing £45 billion bailout, yet despite promises of “root and branch reform” it has since been at the centre of a series of corruption scandals involving record breaking fines.

RBS poor performance has continued, reporting 2015 as its eighth consecutive loss-making year⁴. Despite this, UK Chancellor George Osborne has begun the process of selling off the government’s stake, in what is set to be a net loss to the taxpayer of £13 billion⁵.

This decision has been taken even though few of the underlying issues with the bank exposed by the financial crisis have been resolved. The bank is putting nearly £1 billion aside for future fines and penalties, and on 1 December 2015 it only passed a Bank of England ‘stress test’ because of prior action to boost cash reserves to meet the 3% leverage ratio threshold⁶.

It is hard to make the case that RBS is now meeting its responsibilities to society and the economy. It is increasingly unreliable as a source of accessible banking in local areas: despite promising in 2010 that it would “never” cut the last RBS branch in any town, over 165 have since been closed, leaving customers needing to travel to access banking services⁷.

³ ‘RBS Annual Report’ (2008) Available at: <http://www.investors.rbs.com/~media/Files/R/RBS-IR/annual-reports/rbs-group-accounts-2008.pdf>

⁴ The Guardian, ‘RBS pays chief executive Ross McEwan £3.8m as it reports £2bn loss’ (2016) Available at: <http://www.theguardian.com/business/2016/feb/26/rbs-chief-executive-ross-mcewan-pay-2bn-loss-results-royal-bank-of-scotland>

⁵ Greenham, T. ‘Calculating the loss: counting the true cost of an RBS firesale.’ New Economics Foundation (2015) Available at: http://b3cdn.net/nefoundation/5e17ffbcdbfaa35cb3_6zm6bn15d.pdf

⁶ Bank of England, ‘Stress Testing the UK banking system: 2015 results’ (2015) Available at: <http://www.bankofengland.co.uk/financialstability/Documents/fpc/results011215.pdf>

⁷ Move Your Money, ‘Taxpayer-owned RBS the worst bank for branch closures’ (2015) Available at: <http://moveyourmoney.org.uk/branch-closures/>

Neither is it a source of efficient cash flows for local economies, The Herald reported last June⁸ that the bank had reduced its lending to small businesses over the previous 18 months by as much as £2 billion.

Finally, the bank's record on the environment remains dire. Scotland's last coal fired power station closes in March 2016, yet RBS continue to finance new coal worldwide – US \$1.8 billion in 2014⁹. The Scottish Parliament has consistently opposed nuclear weapons, but RBS have been found to be investing US\$ 7 billion in companies involved in their manufacture¹⁰.

The New Economics Foundation (NEF) has proposed an alternative to the RBS sell-off – the creation of 130 'people's banks' with shared back office infrastructure – which could diversify and democratise the banking sector, making it more resilient to shocks and supporting productive economic development¹¹. In the right hands, the government majority stake in the bank could be used to create a watershed, where big banks are in future restructured as tools for the common good. But with Osborne well on the way to RBS' re-privatisation, Scotland should not look to the UK Government for any prospect of serious reform to Scottish banking. Instead, it should come up with its own plan.

⁸ The Herald, 'Royal Bank of Scotland slashes lending to SMEs again' (2015) Available at:

http://www.heraldscotland.com/business/13645469.ROYAL_Bank_of_Scotland_slashes_lending_to_SMEs_again/

⁹ Rainforest Action Network, Sierra Club and Banktrack, 'The End of Coal?' (2015) Available at:

http://www.banktrack.org/show/pages/2015_coal_finance_report_card_report

¹⁰ ICAN, 'Don't Bank on the Bomb', (2015) Available at: http://www.dontbankonthebomb.com/wp-content/uploads/2015/11/2015_Report_web.pdf

¹¹ Greenham, T. Prieg, L. 'Reforming RBS: Local Banking for the Public Good', *New Economics Foundation* (2015) Available at: <http://www.neweconomics.org/publications/entry/reforming-rbs>

Diagnosing the problem: Scotland's unsustainable banks

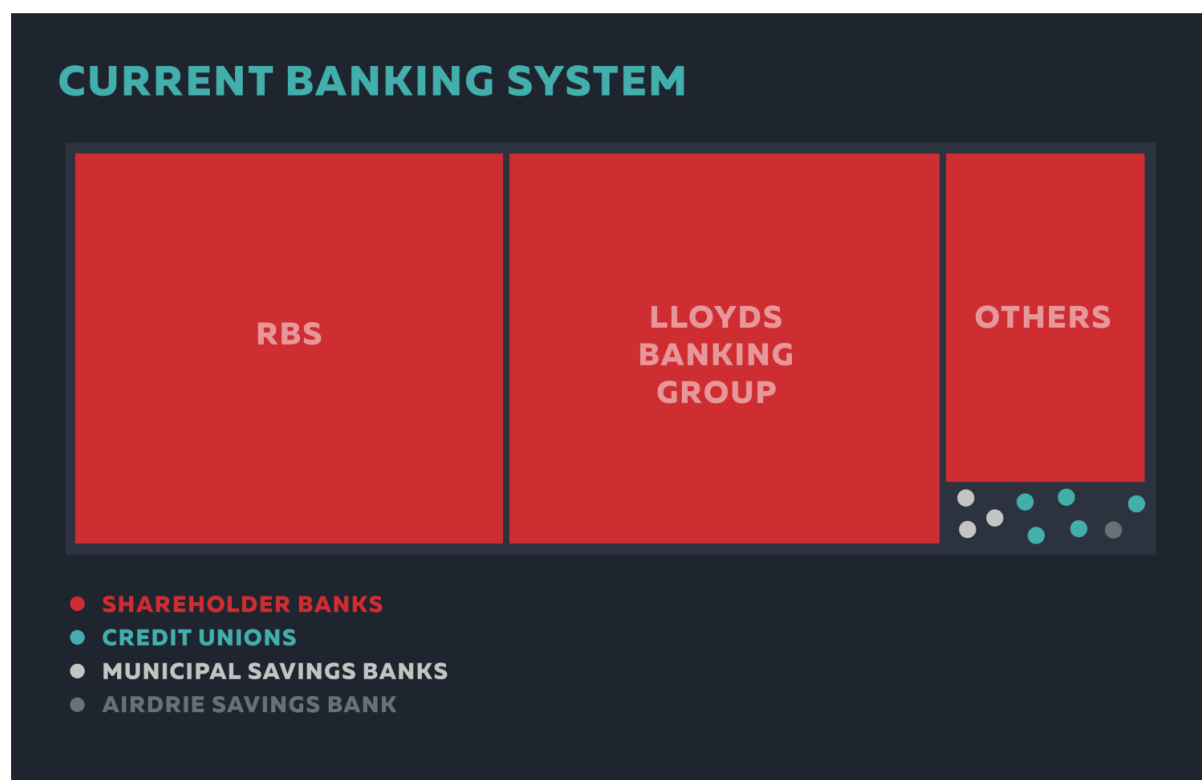


Figure A: High-street banking in Scotland is currently dominated by just two companies: Lloyds Group, trading as the Bank of Scotland, and the Royal Bank of Scotland.

Concentration and instability

Inadequate competition in banking is a long-standing difficulty. Many of the problems identified by the Parliamentary Commission on Banking Standards, the Independent Commission on Banking and the 2002 Competition Commission market investigation persist. The UK SME banking sector remains dominated by four major banking groups, who among them have a market share in England and Wales of 85 per cent. The largest firms have the lowest satisfaction scores.

Treasury Select Committee 'Conduct and competition in small and medium sized enterprise lending', 10 March 2015

Across the whole of the UK, five banks control around 85% of the market¹². In Scotland, the level of concentration is even worse due to the vast market share of RBS and Bank of

¹² The Treasury Select Committee, 'Competition and Choice in Retail Banking', (2011) Available at: <http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/612/61204.htm#note19>

Scotland, being deemed “highly concentrated” by the Competition and Markets Authority¹³. In 2008, this concentration gave the UK government little choice other than to ‘bail out’ failing banks. This is what’s known as the ‘too-big-to-fail’ guarantee, which increases our vulnerability to shocks and systemic risk. Because the banks are all of one type – universal, shareholder-owned banks – this magnifies the instability in our system, making us less able to weather economic shocks like banking crises. Indeed, the UK banking sector is one of the least diverse of any developed country in terms of ownership type (see Figure B).

The 2008 banking crisis cost the UK taxpayer £1,162 billion in peak support up to 2010, and required on-going support to the value of £115 billion in 2014/15¹⁴.

The impact on the UK economy has been enormous, with estimates that the economy is up to £7,400 billion worse off¹⁵.

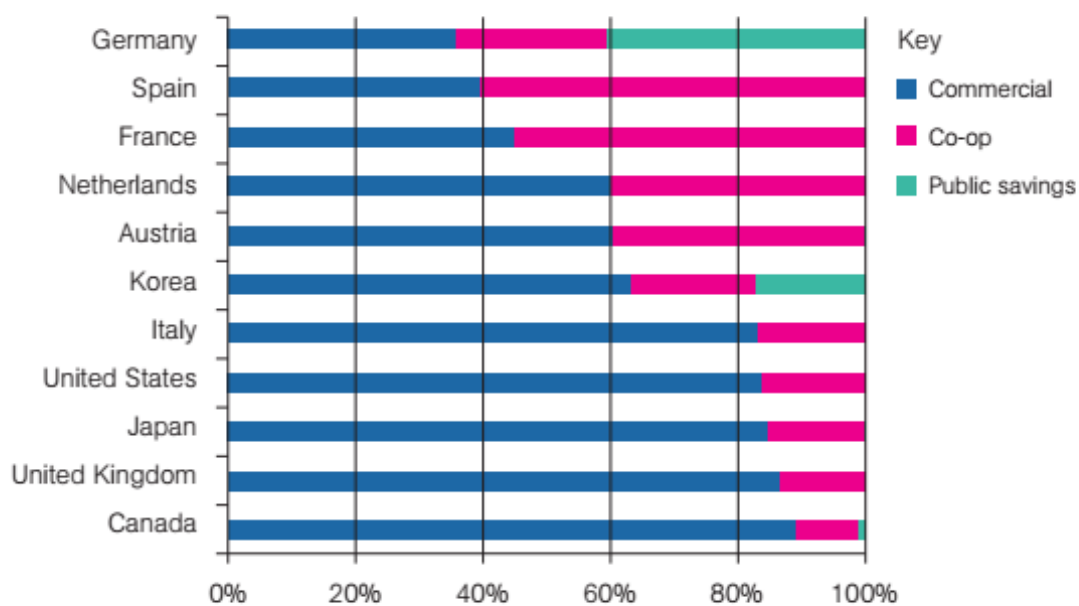


Figure B: By international standards the UK banking sector is highly dominated by commercial banks¹⁶

¹³ Competition and Markets Authority, ‘Personal Current Accounts: Market Study Update’ (2014: p28)

¹⁴ National Audit Office, ‘Taxpayer support for UK banks: FAQs’, Available at:

<http://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>

¹⁵ O’Grady, S. ‘Credit crisis cost the nation £7trn, says Bank of England’, *The Independent* (2010) Available at:

<http://www.independent.co.uk/news/business/news/credit-crisis-cost-the-nation-1637trn-says-bank-of-england-1931569.html>

¹⁶ Greenham, T. Prieg, L. ‘Reforming RBS: Local Banking for the Public Good’, *New Economics Foundation*,

(2015) Available at: <http://www.neweconomics.org/publications/entry/reforming-rbs>

The UK was the second last G7 economy to recover from the 2008 crisis and it took until June 2015 for the economy to return to its pre-crisis peak¹⁷. That's more than 6 years of credit crunch, recession and stagnation all caused by irresponsible bank lending, 'exotic' financial instruments and a hands-off regulatory approach.

Excessively concentrated banking systems are less resilient to shocks. Germany has a highly diverse banking system which lends counter-cyclically, driving economic development during recessions.

The concentration of retail banking in Scotland exposes it to increased downside risk in any future financial crisis. There is more likely to be a systemic crisis in the first place if we continue to have a small number of big banks acting in the same way at the same time. If, following another financial crisis, banks stop or reduce their lending, the wider economy will suffer.

Under-provision of local services

The UK has only one 'type' of bank, and one 'type' of scale: big, universal, shareholder-owned commercial banks. These banks can, in good times, generate high returns on equity for their shareholders. However, the need for such profits – typically over 12% return on equity¹⁸ – and their large size, mean they are not well-suited to take account of local or regional concerns nor to provide for the least well-off:

The poorest in society are often excluded from accessing basic banking services. Analysis from Glasgow Housing Association found in 2012 that at least 1 in 5 of their households, but perhaps as many as 1 in 3, were unbanked¹⁹. In the UK, there are currently 2 million people who are unbanked²⁰.

¹⁷ Tovey, A. 'UK economy finally returns to pre-crisis level', *The Telegraph*, (2015) Available at: <http://www.telegraph.co.uk/finance/economics/10990250/UK-economy-finally-returns-to-pre-crisis-level.html>

¹⁸ 'RBS Independent Lending Review', p.21 (2013) Available at: http://www.independentlendingreview.co.uk/RBS_ILR_Full_Report.pdf

¹⁹ Alexander, N. 'The unbanked in Glasgow and the impact of universal credit', *Niall Alexander Consulting* (2012) Available at: http://www.welfareformscotland.co.uk/downloads/The_Unbanked_in_Glasgow_and_the_Impact_of_the_Universal_Credit.pdf

²⁰ See <http://www.financialinclusioncommission.org.uk/facts>

The financially excluded face a poverty premium: paying higher prices because of limited financial and communications capabilities and high interest on consumer credit²¹. In 2011 it was estimated by Save the Children²² that poor families pay an extra £1,300 per year for basic goods and services.

Local branches are shutting down at an alarming rate. RBS closed 385 branches in 2014-15, 165 of which were the 'last bank in town'²³, leaving more towns than ever without any permanent banking services²⁴. The Campaign for Community Banking Services has revealed that there are now 1,500 communities who now have no branch access²⁵. Early in 2015, banking groups came to an agreement with the UK Government to abandon the 'last bank in town' pledge, signalling their continued lack of interest in providing branch services.

Large banks are structurally ill-suited to respond to local needs because decision-making powers have been largely removed from local experts leading to a reliance on aggregated credit scoring which discriminates against poorer and more vulnerable people, as well as new businesses without a credit history.

Lack of socially useful investment

The entire UK has a long-standing problem of inadequate flows of socially useful investment, including in crucial areas such as housing, energy and transport infrastructure as well as continued under-investment in small and medium enterprises (SMEs). A just transition to a sustainable economy needs substantial investment, yet Scotland is regularly

²¹ Tinson, A. Kenway, P. Bushe, S. MacInnes, T. 'Poverty and the Cost of Living', *Joseph Rowntree Foundation* (2014) Available at: <https://www.jrf.org.uk/report/poverty-and-cost-living>

²² Williams, R. 'Poor families must pay an extra £1,300 per year for basic goods and services', *The Guardian* (2011) Available at: <http://www.theguardian.com/uk/2011/jan/11/poverty-premium-poor-families>

²³ Move Your Money, 'Taypayer-owned RBS the worst bank for branch closures' (2015) Available at: <http://moveyourmoney.org.uk/branch-closures/>

²⁴ Online banking has undoubtedly changed how many people engage with banks, however some of the functions of branches cannot be replaced with technology. The Federation of Small Businesses (FSB) in Scotland has criticised branch abandonment, stressing the needs of businesses to deposit cash locally, and to meet with bank managers to do business. See <http://www.fsb.org.uk/news.aspx?rec=8987>

²⁵ For the latest data see <http://www.communitybanking.org.uk/report-reduction-2015.htm>

missing its own carbon emissions reduction targets²⁶. The under-funding of its plans for meeting them (RPP2) has been a concern for environmental organisations²⁷.

Infrastructure

The current banking system is ill-equipped to support investment in the real economy with currently less than 10% of lending by UK domestic banks going to businesses for productive investment²⁸. Of that lending, there are no mechanisms in place to ensure banks lend to the areas most in need of support (for example renewable energy) so banks instead make their decisions based on the amount of short-term profit generated.

The private sector has been reluctant to invest in infrastructure projects without public backing, blaming high upfront costs and long payback periods²⁹. Big banks in search of high, short-term profits are unwilling to lend to projects requiring 'patient capital' – meaning investments which offer low, stable returns over a long time frame. For example, community energy projects and start-up businesses may only begin making profits several years into their operation.

Smaller businesses

In March 2015, there were 359,050 small and medium-sized enterprises (SMEs) operating in Scotland, providing an estimated 1.2 million jobs. SMEs accounted for 55.6% of private sector employment³⁰, meaning that a lack of investment in the SME sector would have a considerable impact on the availability of jobs³¹.

26 BBC News 'Scotland misses greenhouse emission target' (2015) Available at:

<http://www.bbc.co.uk/news/uk-scotland-scotland-politics-33058391>

27 Written submission by Stop Climate Chaos Scotland to the Scottish Parliament Infrastructure and Capital Investment Committee (2014) Available at:

http://www.scottish.parliament.uk/S4_InfrastructureandCapitalInvestmentCommittee/14.10.30_Stop_Climate_Chaos_Scotland.pdf

²⁸ By productive investment we are referring to investment in the 'real economy', i.e. discounting lending for financially speculative activities. The Bank of England, 'Industrial analysis of sterling monetary financial institutions lending to UK residents' (Figure includes UK domestic banks only) Available at:

<http://www.bankofengland.co.uk/boeapps/iadb/index.asp?first=yes&SectionRequired=C&HideNums=-1&ExtraInfo=false&Travel=NlxSTx>

²⁹ Helm, D. 'Infrastructure and infrastructure finance: the role of the government and the private sector in the current world', *EIB Papers* (2010) 15(2): 8–27

³⁰ The Scottish Government, 'Businesses in Scotland 2015', (2015) Available at:

<http://www.gov.scot/Topics/Statistics/Browse/Business/Corporate>

Large banks are attracted to large-scale loans because they are less labour intensive for the profits returned. Viable smaller businesses looking for loans are not, because of their size, attractive to profit-maximising banks.

SME lending has only just begun to grow for the first time since the recession, but over two thirds of that lending is going to businesses in London and the South East³². The range of policies and subsidies offered by the government and the Bank of England have taken a long time to have any impact, and this impact is skewed geographically, with regions losing out.

Area	Percentage of total SME lending ³³
London	20%
South East England	13%
North West England	11%
South West England	11%
West Midlands	9%
Scotland	8%
Yorkshire and the Humber	8%
East of England	8%
East Midlands	6%
Wales	5%
North East England	3%

Figure C: UK banks' SME lending by areas in the UK, September 2014

³¹ See <http://www.fsb.org.uk/stats>

³² Bounds, A. 'SME lending grows for the first time since the financial crisis', *The Financial Times* (2016)
Available at: <http://www.ft.com/cms/s/0/db2a1686-c8e4-11e5-be0b-b7ece4e953a0.html#axzz3zb8DCZpq>

³³ British Banking Association, 'BBA figures for Q3 2014' (2014) Available at:
<https://www.bba.org.uk/news/statistics/postcode-lending/lenders-set-out-levels-of-borrowing-from-across-the-country-q1-2015/#.Vi4w8X7hDcs>

Whilst it is difficult to untangle supply and demand issues when it comes to SME borrowing, a range of surveys suggest credit conditions for SMEs have still not returned to pre-crisis conditions, in contrast to that for larger firms³⁴.

Furthermore, the lending which does go to SMEs is extremely regionally unbalanced, with 33% going to London and the South East and just 8% to Scotland (see *Figure C*).

Smaller businesses have embraced alternative sources of finance such as peer-to-peer and online platforms – but volumes are still too low, with alternative finance contributing only £1.74 billion of lending to SMEs in the first half of 2015³⁵.

Transition to a low-carbon economy

The Scottish Government has recognised the pressing issue of climate change and set into law ambitious CO2 reduction targets, committing Scotland to making reductions of 42% by 2020 and 80% by 2050³⁶.

The sums required for investment to make this transition are huge. At a UK level, for electricity generation, up to £110 billion is needed by 2020 to meet increased demand and replace capacity³⁷. If upgrades to the grid and energy supply more broadly are included this figure could rise to £200 billion³⁸.

Despite this, low-carbon infrastructure is underfunded. The UN Environmental Programme states that “despite the increasing competitiveness of many clean technologies, and concern over the valuation and market volatility risks of carbon-intensive assets, there remains a structural under-investment in sustainable assets and an over-investment in resource-intensive assets”³⁹.

³⁴ McCafferty, I. ‘UK business finance since the crisis – moving to a new normal? Speech, Bank of England At Bloomberg London’, *Bank of England*, p5-6 (2015)

³⁵ Nesta, ‘Understanding Alternative Finance’ (2014) Available at:

<http://www.nesta.org.uk/sites/default/files/understanding-alternative-finance-2014.pdf>

³⁶ The Scottish Government, ‘Meeting our Emissions Reductions Targets’, (2015) Available at:

<http://www.gov.scot/Topics/Environment/climatechange/meetingemissionstargets>

³⁷ Department of Energy and Climate Change, ‘Planning Our Electric Future: A White Paper for Secure, Affordable and Low-Carbon Electricity’ (2011)

³⁸ Ernst and Young, ‘Powering the UK: the role of the power and gas sector in the wider economy’, (2011)

Available at: [http://www.ey.com/Publication/vwLUAssets/Powering_the_UK/\\$FILE/Powering_the_UK.pdf](http://www.ey.com/Publication/vwLUAssets/Powering_the_UK/$FILE/Powering_the_UK.pdf)

³⁹ United Nations Environment Programme, ‘Aligning the financial system with sustainable development: Insights from Practice’ (2014)

Socially damaging investments

Scottish banks are significant investors in companies which are accused of damaging the global environment and undermining Scottish Government policy aimed at reducing carbon emissions. Having previously boasted of its specialist credentials in financing fossil fuels⁴⁰ RBS remains a major global investor in dirty industry, financing coal extraction and power generation to the tune of US \$1.8 billion in 2014 alone⁴¹.

Research by international disarmament campaigners shows that the UK hosts 26 financial institutions which fund nuclear weapons manufacturers. Among the most significant were the Lloyds Banking Group, which invests US\$ 1.9 billion in companies involved in the manufacture of nuclear weapons, and RBS, which invests US\$ 7 billion in such companies⁴².

These investments were being made after these banks received billions, first in the form of the 2008 bailouts, and later in several rounds of quantitative easing, cumulatively valued at £375 billion⁴³. Evidence has shown that there is a weak relationship between quantitative easing and the delivery of finance to individuals and companies in the real economy⁴⁴.

Instead a huge volume of finance is delivered to speculative activities: Along with several of the UK's other largest banks, RBS and Lloyds Group were listed in a report detailing companies which were fuelling hunger by channelling investment into speculation on food prices and land-grabbing in the southern hemisphere⁴⁵.

Aside from dubious investment strategies, Scottish based banks have lost billions in fines and charges from criminal and negligent activity⁴⁶, including the fixing of foreign exchange

⁴⁰ Platform and People & Planet, 'The Oil and Gas Bank', (2007) Available at: <http://platformlondon.org/publications/the-oil-gas-bank-rbs-the-financing-of-climate-change/>

⁴¹ Rainforest Action Network, Sierra Club and Banktrack, 'The End of Coal?' (2015)

⁴² ICAN, 'Don't Bank on the Bomb', (2015) Available at: http://www.dontbankonthebomb.com/wp-content/uploads/2015/11/2015_Report_web.pdf

⁴³ BBC News, 'What is quantitative easing?' (2015) Available at: <http://www.bbc.co.uk/news/business-15198789>

⁴⁴ Collins, J. et al. 'Strategic Quantitative Easing', *The New Economics Foundation*, (2013: p.22) Available at: http://b3cdn.net/nfoundation/e79789e1e31f261e95_ypm6b49z7.pdf

⁴⁵ Friends of the Earth Europe, 'Farming Money', (2012) Available at: https://www.foeeurope.org/sites/default/files/publications/Farming_money_FoEE_Jan2012.pdf

⁴⁶ BBC News, 'RBS Struggles Against Never-ending Fines', (2014) Available at: <http://www.bbc.co.uk/news/business-30127970>

rates, rigging interest rates and the mis-selling of payment protection insurance, among other scandals.

Barriers to change

Payment systems: Locking the door to alternatives

Payment systems are a vital part of the UK economy, processing around £7,500 billion each year⁴⁷. Every time you pay a bill, receive your salary in your bank account, pay by cheque, get money out of a cash machine or transfer money to family or friends you are accessing vital infrastructure.

This infrastructure is mainly owned and controlled by the biggest banks, giving them the power to decide who can access payment systems and at what cost. This amounts to a major conflict of interest as established banks have the ability to make access to payment infrastructure difficult in order to discourage competition. This has prevented the arrival of new banks and had a knock-on effect on payment system innovation⁴⁸.

On the 1 April 2015, the Payments Systems Regulator came into force, regulating eight major payment systems in the UK, including BACS, CHAPS and Visa. This body aims to deal with some issues surrounding competition, however as the problems sit in the wider space between payment systems and banking, it is unlikely the new regulator will have the power to compel those who control payment systems to provide fair access. It also is not tasked to look at the diversity of financiers accessing these systems.

Regulation: Built for the Big Banks

The current regulatory system has been largely built around the needs and requirements of large scale, universal banks. Following changes made in the aftermath of the financial crisis, the rules governing banks are now more supportive of new banks, but there is perhaps some way still to go. In January 2016 the 'New Bank Start Up Unit' was created by UK

⁴⁷ The Payment Systems Regulator, 'The PSR Purpose', Available at: <https://www.psr.org.uk/about-psr/psr-purpose>

⁴⁸ Financial Conduct Authority, 'A New Regulatory Framework for Payment Systems in the UK' (2014) Available at: <https://www.fca.org.uk/static/documents/psr/psr-cp14-1-cp-a-new-regulatory-framework-for-payment-systems-in-the-uk.pdf>

regulators (the Prudential Regulation Authority and the Financial Conduct Authority) to support new market entrants seeking regulation⁴⁹.

These developments have undoubtedly contributed to the arrival of eight new banking institutions between 2010 and 2015⁵⁰. However, these new banks are largely of the shareholder business model and many do not offer current accounts, or they operate only as online banks. We are so far seeing increased competition, but not increased diversity, which is what is sorely needed.

Alternative institutions

Scotland's last local bank: the Airdrie Savings Bank

The Airdrie Savings Bank offers a full range of services including current accounts, savings, loans, mortgages and internet banking. It is notable in three respects, firstly, as the last remaining trustee savings bank, having remained independent since its formation in 1835, avoiding the TSB consolidation in the 1980s. Secondly, because it operates as a branch based bank with local managers able to make loan decisions and tailor some products to individual customers. Finally, because it is a mutual organisation, run by its board of (unpaid) trustees in the interests of its customers – there are no shareholders.

In 2015, the bank announced the closure of 4 of its 8 branches as part of a strategic review in response to banking sector challenges⁵¹. Airdrie has around £150 million in deposits, with a further £52 million in loans⁵². *Airdrie* advocates the founding of community banks across the UK through its support for the Community Services Banking Association⁵³.

Municipal banks

In Scotland there are three municipal banks, North Ayrshire Municipal Bank, North Lanarkshire and Clydebank. The name is somewhat misleading as the institutions are much closer in nature to savings schemes and in practice have limited banking functions. Savers

⁴⁹ Financial Conduct Authority, 'New Bank Start Up Unit launched by the financial regulators' (2016) Available at: <https://www.fca.org.uk/news/new-bank-startup-unit-launched-by-the-financial-regulators>

⁵⁰ HM Treasury, 'A Better Deal: boosting competition to bring down bills for families and firms', p.12 (2015)

⁵¹ McCulloch, S. 'Airdrie Savings Bank to close four branches', *The Daily Record* (2015) Available at: <http://www.dailyrecord.co.uk/business/business-news/airdrie-savings-bank-close-four-5778131>

⁵² Vander Weyer, M. 'Welcome Back, TSB: your founders spirit is alive and well and living in Airdrie', *The Spectator* (2013) Available at: <http://www.spectator.co.uk/columnists/any-other-business/9017761/welcome-back-tsb-your-founders-spirit-is-alive-and-well-and-living-in-airdrie/>

⁵³ For more information visit <http://www.csba.co.uk/>

deposit money, either in person at an office (usually a council building or subsidiary) during council opening hours, or by direct debit. This money goes directly into the council's bank account as part of their regular cash flow as an alternative to market borrowing. Interest rates are reassessed regularly to keep them in line with market rates to try and ensure a balance between benefit to the saver and value for the council. They are small in scale, services are limited, and accounts are defined via accounting systems rather than having separate bank accounts for each customer.

Credit unions

Credit unions are mutual and ethical organisations that offer savings and loans to people with a defined 'common bond': living in the same area, working for the same employer or being part of a club or society.

1 in 20 people in Scotland are members of a credit union; there are 113 credit unions serving over 250,000 people, with savings of over £200 million and around £170 million out on loan⁵⁴. Credit unions vary in their facilities but can offer current accounts, life savings insurance, cash ISAs and mortgages. The Glasgow credit union is the largest in the UK.

Challenger banks

The UK has seen an increase in applications for banking licences⁵⁵. However, the introduction of a number of small challenger banks, often digital-only, has had little overall impact on the sector. London-based Metro Bank, one of the few to gain any kind of foothold, was the first new high-street bank to open in the UK in 150 years.

Public sector investors

Scottish Investment Bank

Not a true bank, the Scottish Investment Bank is the investment arm of Scottish Enterprise, Scotland's main economic development agency, which exists to support economic growth by providing finance to Scottish businesses.

In 2014-15 they invested £66.5 million, 'crowding in' £99 million of private investment, which they say helps their portfolio companies provide over 3,500 jobs in Scotland. Their overall portfolio of 275 companies is heavily focused on tech engineering and life and chemical sciences, with an increasing interest in renewables. Of their recent investments,

⁵⁴ See the Association of British Credit Unions Scotland: <http://www.abculscotland.coop/home>

⁵⁵ Treanor, J. 'UK Challenger Banks Aim to Loosen the Grip of the Big Four', *The Guardian* (2015) Available at: <http://www.theguardian.com/business/2015/jun/01/uk-challenger-banks-aim-to-loosen-grip-of-big-four>

54% were in renewables through their Renewable Energy Investment Fund. A total of £32.4 million went into 21 deals, 9 of which were for community energy, 9 for marine energy and 3 for low cost energy production. They also raised £64.5 million of additional private and public sector investment. Their investments generated £9.5 million of income in 2014-15, principally due to exiting five successful investments. Scottish Enterprise has plans to invest almost £1 billion in the Scottish economy between 2015-2018⁵⁶.

Scottish Futures Trust

The Scottish Futures Trust is an independent company set up by the Scottish Government in 2008 with the aim “to improve the efficiency and effectiveness of infrastructure investment in Scotland by working collaboratively with public bodies and industry, leading to better value for money and ultimately improved public services”⁵⁷. The Scottish Futures Trust say that they have delivered £135 million of “net benefits and savings” to infrastructure investment.

Critics point out that the Scottish Futures Trust is structured as a Public Private Partnership (PPP) and therefore, like its cousin the Private Finance Initiative (PFI), is not cost effective for the taxpayer. The core benefit of using either of these models rather than direct government investment is that accounting rules allow PFI/PPP contracts to remain off Government debt balance sheets, despite being more expensive in the long run⁵⁸.

UK Green Investment Bank

The Green Investment Bank launched in late 2012 with £3.8 billion of public money, and has committed nearly £2 billion to around 50 projects. The UK Government was the sole shareholder with a business model of matching public funds with private capital – the 2014-2015 annual report showed that every £1 of public money attracted £3 of private money⁵⁹. The Green Investment Bank teamed up with Strathclyde Pension Fund to fund the

⁵⁶ Scottish Enterprise, ‘Scottish Investment Bank Annual Review 2014-2015’ (2015) Available at:

<http://www.scottish-enterprise.com/about-us/what-we-do/investment/sib/sib-annual-review-2015>

⁵⁷ Scottish Futures Trust, ‘About Us: Our Aim’, Available at: <http://www.scottishfuturestrust.org.uk/about-us/aim-investments-funding-and-our-partners/>

⁵⁸ Watson, D. Montgomery, F. ‘PPP/PFI Projects in Scotland’, *Unison Scotland* (2011) Available at:

<http://www.unison-scotland.org.uk/comms/pfi.html>

⁵⁹ Green Investment Bank, ‘Annual Report and Accounts 2014-2015’, Available at:

<http://www.greeninvestmentbank.com/governance/governance-documents/annual-reports/>

renewable project Crianlarich Hydro, showing that community scale investments are possible⁶⁰.

Some argue that the Green Investment Bank simply acts as any other commercial lender would – lending only at market rates – when the role of a state investment bank should be to fill gaps where the market is unable or unwilling to lend. For example, it should provide funds to newer technologies, charge lower rates or allow more flexible terms. Critics argue that the Green Investment Bank’s over-cautious approach is partly responsible for the failure of the Green Deal, leading to a complicated system with high interest rates⁶¹.

Changes proposed by the current UK Government will see part-privatisation of the Green Investment Bank and would remove the bank’s requirement in law to invest in green projects⁶².

Moving Forward

The current banking system is failing parts of the SME sector and under-funding or refusing investment in the future potential of Scottish people, businesses and society.

Our financial institutions are denying bank accounts to vulnerable people and are retreating from branch banking, leaving many communities and those living in remote locations without an essential service.

Banking services should be considered a public good – everyone needs access to banking services, including traditional branch banking and innovative online technology. Where privately-owned provision is not providing such a service, intervention is required.

Those few banking institutions which operate in a more sustainable and responsible way lack the support which would enable them to make a significant contribution to Scottish society.

This banking system is not providing the necessary services or investments needed to transition to a just and sustainable economy.

⁶⁰ BBC News, ‘Scots hydro scheme first for green investment funding’ (2015) Available at:

<http://www.bbc.co.uk/news/uk-scotland-tayside-central-31493508>

⁶¹ Clark, P. ‘Green Investment Bank accused of behaving like commercial lender’, *The Financial Times* (2015)

Available at: <http://www.ft.com/cms/s/0/1cc61e1a-3a00-11e5-bbd1-b37bc06f590c.html#axzz3zTr6xq00>

⁶² Vaughn, A. ‘Green investment bank no longer required by law to invest in green projects’, *The Guardian*

(2016) Available at: <http://www.theguardian.com/environment/2016/feb/23/green-investment-bank-will-no-longer-be-required-by-law-to-invest-in-green-projects>

Our analysis is that the big banks are structurally unable to cater to the many and varied needs that individuals, communities, businesses and the wider economy have. There is clearly a need for something different. What is it?

What is missing in our current system is the recognition that banking needs to happen at different scales – from the national level, down through regional networks to community level; through different ownership and business models.

We need a space in our banking system for institutions which are more local, more accessible and more trusted, providing lending for vital services which big banks ignore.

Useful banking: learning from elsewhere

National investment banks

National investment banks or development banks are government sponsored or funded financial institutions that provide strategic and usually long term finance to industry⁶³.

They are recognized as having played a crucial role in the rapid industrialisation process of Continental Europe and Japan through the 20th Century⁶⁴ and they are also seen as playing a key role in the rapid growth of East Asian countries in the 1970s and 1980s – the so called ‘East Asian miracle’⁶⁵.

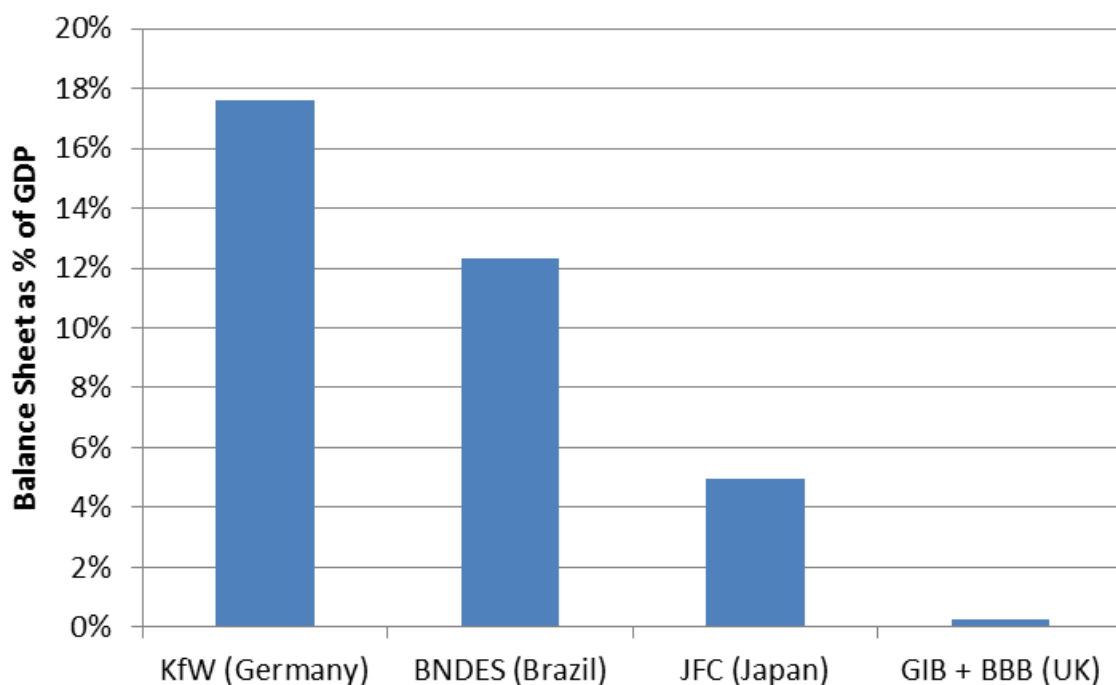


Figure D: State Investment Banks by balance sheet size⁶⁶

⁶³ De Aghion, B. ‘Development banking’, *Journal of Development Economics* (1999) 58:1, p83-100

⁶⁴ See Gerschenkron, A. *Economic backwardness in historical perspective: a book of essays* (1962); Zysman, J. ‘Governments’ in *Markets and Growth: Financial Systems and the Politics of Industrial Change*, (1983) 21-1

⁶⁵ Amsden, A.H. *The rise of the rest: challenges to the west from late-industrializing economies*, (2001); Stiglitz, J. ‘Some lessons from the East Asian miracle’, *The World Bank research observer*, (1996): 11.2 p.151-177

⁶⁶ Collins, J. Greenham, T. Bernardo, G. Werner, R. ‘Strategic Quantitative Easing’, New Economics Foundation (2013)

Existing national investment banks include the KfW (*Kreditanstalt für Wiederaufbau*, Germany); BILLIONDES (Brazilian Development Bank); the US Small Business Administration; the European Investment Bank (EIB); and the Nordic Investment Bank.

In most cases, national investment banks are structured at arm's length from governments and their assets do not add to public sector deficits.

There is an impressive body of evidence on the benefits of national investment banks:

- A comprehensive study of 128 countries found that significant government ownership of banks during the 1995-2007 period was associated with higher growth of between 1.6-1.9% per annum⁶⁷.
- A study of 1,633 banks from 111 countries over the 1999–2010 period found that lending by state banks creates greater stability in the economy than lending by private banks, especially in countries with good governance⁶⁸.
- Bank-level studies in Germany⁶⁹, Russia and China⁷⁰ all show that public banks are more efficient than private banks.

Recently, research has emphasized the vital role of the state and development banks in stimulating innovation because of their capacity to provide patient long-term capital to emerging sectors, such as green energy, that private sector venture capital finds too risky⁷¹.

The UK is highly unusual in not having a major national investment bank. Institutions like the British Business Bank and the Green Investment Bank do not parallel the role or scale of state investment banks in other countries (*see Figure D*).

⁶⁷ Andrianova, S. Panicos, D. Anja. S. 'Government ownership of banks, institutions and economic growth', *Economica* (2012): 79.315 p.449-469.

⁶⁸ Bertay, A.C. Demirgüç-Kunt, A. Huizinga. H. 'Bank ownership and credit over the business cycle: Is lending by state banks less procyclical?', *Journal of Banking & Finance* (2015) 50 p.326-339

⁶⁹ See Altunbus, Y., Evans, L. and Molyneux, P. 'Bank ownership and efficiency', *Journal of Money, Credit and Banking*, (2001); 33(4), p.926–54;. Seaford, C, et al. 'A British Business Bank', *New Economics Foundation* (2013)

⁷⁰ See Karas, A. Schoors, K. Weill, L. 'Are private banks more efficient than public banks? Evidence from Russia', *Bank of Finland* (2008); Rousseau, P. and Xiao, S.' Banks, stock markets, and China's Great Leap Forward', *Emerging Markets Review* (2007) 8, p206–17; Demetriades, P. O Hussein, K.A. 'Does financial development cause economic growth?', *Journal of Development Economics* (1996) 51, p387–411

⁷¹ See Mazzucato, M. *The Entrepreneurial State* (2013) Anthem Press

National investment banks tend to operate according to one of two basic models, with some combining elements of both approaches:

Direct lending and investment

State banks which focus on direct lending need extensive branch networks since this gives them the requisite local knowledge as well as enabling them to meet the needs of their borrowers for branch access.

Banks which follow this approach argue that it makes them more resilient to periods of crisis, when the strategy of lending via other banks may break down.

Examples of national investment banks following this approach include the Business Development Bank of Canada, the Japan Finance Corporation, and the Brazilian Development Bank for larger loans.

Lending through intermediaries

National investment banks such as the Russian Bank for Small and Medium Enterprises Support (SME Bank) and the Nordic Investment Bank (NIB) deliver their lending through intermediaries in two ways.

Some deliver funds via 'on-lending', lending to other banks on the understanding that the money will be lent on to the sector being targeted, such as SMEs or eco business.

Alternatively, national investment banks provide guarantees, taking on some or all of the risk of default to make SME lending more attractive for other banks. This is the practice used by the US Small Business Administration (SBA), Japanese Finance Corporation (JFC) and German and Russian regional banks.

These approaches tend to rely on the presence of a strong local banking sector that can act as a distribution network for loans – something currently lacking in the UK⁷².

⁷² For more on this see Seaford, C. et al. 'A British Business Bank', *New Economics Foundation* (2013)

Side note: Germany's national investment bank

Germany's KfW has a mandate 'to sustainably improve the economic, social and ecological condition of people's lives'. It offers products aimed at improving the environmental efficiency of homes and businesses, as well as programmes to support new environmental technologies and renewable energy generation. It has finance products aimed at supporting human capital development, which offer finance to students and individuals undertaking professional development courses, such as training to become master craftsmen. It also offers products specifically aimed at start-ups, SMEs, social enterprises, research and development activities and feature length films.

Regional, municipal and stakeholder banks

The UK is highly unusual in having virtually no local or regional banking sector (see Figure E).

In most other developed economies, local, municipal and regional banks play a vital economic role in lending to small businesses, maintaining access to banking services for rural communities and rebalancing the economy between regions.

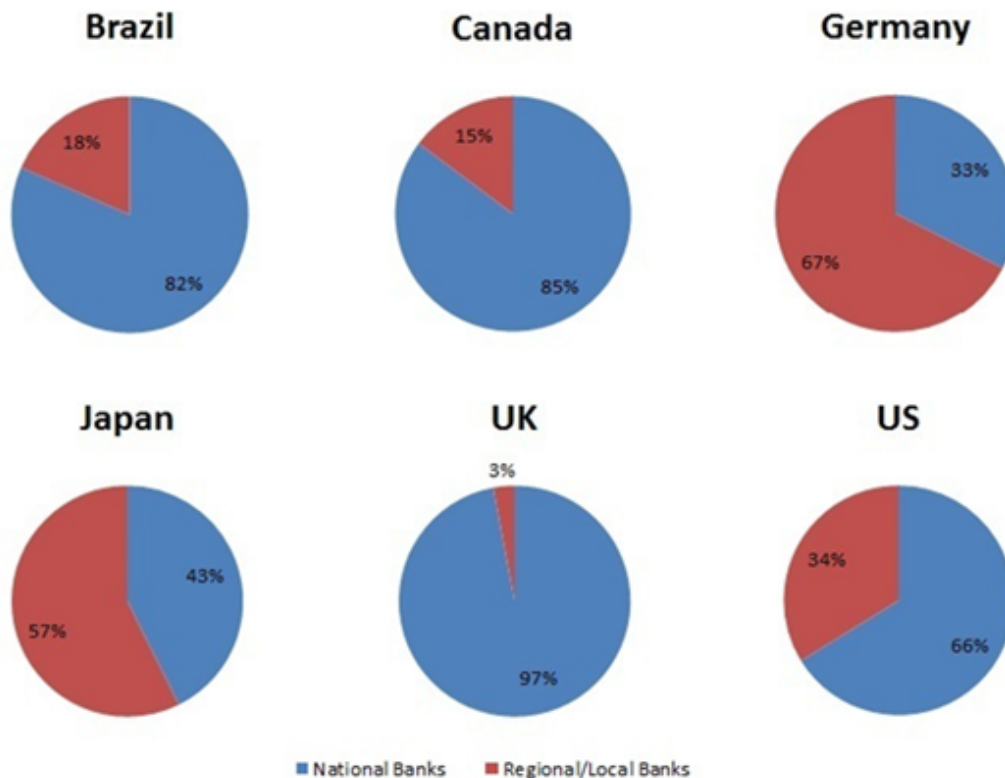


Figure E: Split of banking sector between national and regional/local banks (by assets, except in Japan which is split by lending)

Successful examples of stakeholder banks include:

- **The German *Sparkassen*** – a network of public savings banks, owned in trust for the public benefit and run by local stakeholder boards, with a public interest mandate restricting them to lending within their geographic area. The *Sparkassen* co-own regional banks (*Landesbanken*) to help them manage liquidity and engage in investment banking activities.
- **The Swiss *cantonal banks*** – a network of 24 banks owned by the government (although in the process of being part-privatised), which account for around 30% of the banking sector in Switzerland⁷³.
- **Credit unions in the US** – credit unions form a major part of the North American banking landscape – shared central infrastructure and less restrictive regulation enable credit unions to offer a wider range of financial products. Forty seven percent of the US population are members of a credit union⁷⁴.

These examples contrast with UK banking in their local or regional focus and their ownership and governance models. Some (like the *Sparkassen*) are profit-making but not profit-maximising, while others (like credit unions) are classified as non-profits. All are governed by a broader set of objectives such as customer value, financial inclusion and local economic development. They are sometimes referred to collectively as ‘stakeholder banks’.

Evidence suggests that local stakeholder banks perform well on a number of fronts:

○ **Greater focus on the needs of customers** including more competitive products with lower loan rates and higher deposit rates, better customer service and longer term lending (for example, the German *Sparkassen* provided 45% of long-term business lending in 2012, compared to 20% from commercial banks)⁷⁵.

○ **Promoting financial inclusion** through explicit aims to provide for customers who are under-served by commercial banks and by maintaining more extensive branch networks. In countries like France, Austria and Canada, local stakeholder banks have played a particularly important role in maintaining branch networks in rural areas as commercial banks withdraw from them.

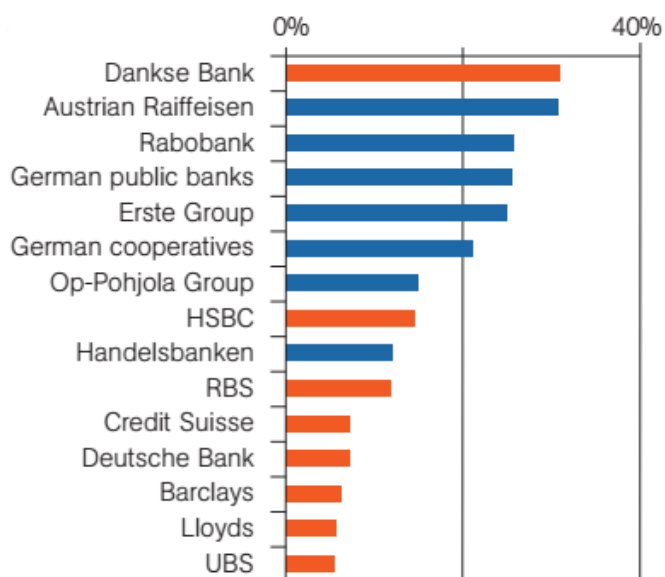
⁷³ Available at: <http://www.kantonalbank.ch/e/mediencenter/publikationen.php>

⁷⁴ World Council of Credit Unions, ‘Statistical Report’ (2014). Available at:

http://www.woccu.org/documents/2014_Statistical_Report

⁷⁵ Deutsche Bundesbank figures cited in Prieg, L. and Greenham, T. ‘Stakeholder banks: Benefits of banking diversity’, *New Economics Foundation* (2013)

○ Positive impact on local economic development: Stakeholder banks are the powerhouses of lending to small and medium businesses in many countries. Large commercial banks lend proportionately less to businesses as a whole (see Figure F) but particularly to small businesses. Studies in Italy⁷⁶ and Germany⁷⁷ suggest they can help with regional rebalancing by preventing capital being sucked into big urban centres.



○ Positive impact on financial stability: Stakeholder banks had less volatile returns, higher levels of capital and less risky business models in the years before the 2008 crisis; they also continued to expand their lending after the crash, when large commercial banks were withdrawing it (see Figure G). A recent academic study of 4,352 banks in 12 European countries over the period 1999–2011 found that following a monetary shock (for example an increase in interest rates), stakeholder banks decrease their loan supply to a lesser extent than shareholder banks⁷⁸.

Key
■ Stakeholder banks
■ Large commercial banks

Figure F: Proportion of bank balance sheets applied to real economy lending and investment

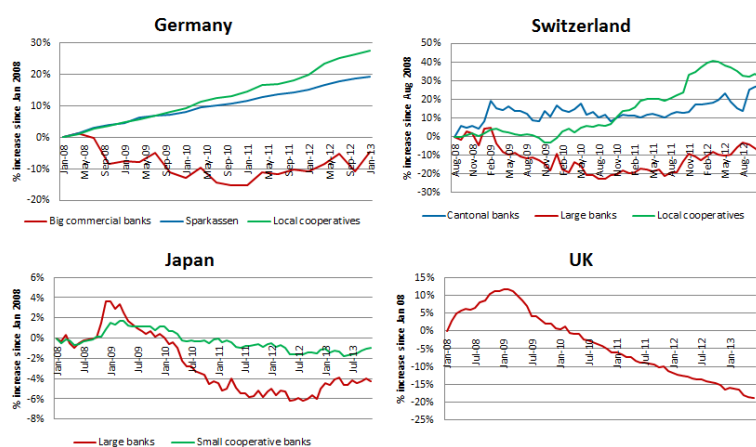


Figure G: Comparison of post-crisis credit growth between large commercial banks and local banking networks.

⁷⁶ Usai, S. Vannini, M. 'Banking Structure and Regional Economic Growth: Lessons from Italy', *Annals of Regional Science*, (2005) 39(4) p.691-714.

⁷⁷ Hakenes, H. Schmidt, R. & Xie, R. 'Public Banks and Regional Development: Evidence from German savings banks', *Social Science Research Network* (2009) Available at: <http://ssrn.com/abstract=1343048>

⁷⁸ Ferri, G. Panu, K. Eeva, K. 'Does bank ownership affect lending behaviour? Evidence from the Euro area', *Journal of Banking & Finance* (2014) 48: p.194-209

Protecting stakeholder banks

German *Landesbanken* (or regional banks) ran into trouble during the financial crisis, raising some concerns about the stakeholder banking model. However, close examination makes clear that the *Landesbanken* failed because they behaved too much like shareholder-owned commercial banks, not too little – getting swept up in the tide of risky trading that originated in big commercial banks.

Prior to the crisis, the *Landesbanken* came under pressure to invest in risky mortgage-backed derivatives in order to compete with the huge profits being made by commercial rivals. This was exacerbated by the loss of state subsidies in 2005 following successful lobbying by German commercial banks⁷⁹.

A similar story can be told about municipal banks in Spain: the *cajas*. Prior to 1989, *cajas* were restricted to serving their local area with a limited range of retail banking activities. Policies aimed at improving efficiency and competition led to these restrictions being removed. This prompted a transformation in the nature of Spanish savings banks:

- Mergers and acquisitions reduced the number of *cajas* from 76 to 54 over the next twenty years⁸⁰.
- They significantly increased their exposure to residential and commercial property construction and mortgages⁸¹.
- *Cajas* changed their funding model from primarily customer deposits to wholesale money markets.
- They started to compete with one another nationally and try to outgrow their rivals.

Spanish property prices tripled in the ten years prior to 2007. In 2004 and 2005, half a million new properties were built per year. By the end of 2008, nearly 30 per cent of these were lying empty⁸². Developers and construction companies went bust and the *cajas*

⁷⁹ Prieg, L. and Greenham, T. 'Stakeholder banks: Benefits of banking diversity', *New Economics Foundation* (2013)

⁸⁰ Centre for European Policy Studies, 'Investigating diversity in the banking sector in Europe: The performance and role of savings banks' (2009) Available at:

<http://aei.pitt.edu/32639/1/62. Investigating Diversity in the Banking Sector in Europe.pdf>

⁸¹ Mallet, V. Johnson, M. 'The bank that broke Spain'. *The Financial Times* (2012)

⁸² Knight, L. 'Spanish economy: What is to blame for its problems?', *BBC News* (2012) Available at:

<http://www.bbc.co.uk/news/business-17753891>

suffered ruinous losses on their loans, precipitating government support, and Spain's request for a bailout from the EU⁸³.

The recent troubles of the Spanish *cajas* and German *Landesbanken* shows the folly of deregulating local stakeholder banks and encouraging them to behave like commercial banks.

If Scotland was to make its banking sector less reliant on large, profit-maximising shareholder banks, it would be travelling in the opposite direction to the risky changes made in Spain and Germany.

The New Economics Foundation (NEF) has identified two key factors which make safe, successful stakeholder banks:

- Maintaining the independence of locally focussed and controlled institutions, while collaborating in networks to gain economies of scale, expertise and pooled liquidity and risk through central institutions and infrastructure.
- Favourable regulation that recognises the distinct nature of stakeholder banks and does not force them to become more like commercial banks.

Cooperation from national to local: the German example

More than any other banking system, the German example illustrates the potentially powerful symbiotic relationship between a national investment bank and a municipal or local banking system. It also illustrates the diverse range of ownership and governance models that public banks can adopt, and the way public institutions can add value to the economy rather than 'crowding out' private investment.

In Germany the KfW lends mostly through secondary financiers and in doing so works with nearly every German bank. The *Sparkassen* and local co-operatives perform most strongly at SME lending due to their local focus, and as such are key partners for the onward distribution of KfW loans.

The *Sparkassen* are a key part of the success story of the German economy, outperforming commercial banks in terms of real economy lending and small business lending, as well as spreading both public and private investment more evenly across geographic regions. *Sparkassen* are also important institutions within their local communities, providing financial support for local cultural, social and sporting activities.

⁸³ Mallet, V. Johnson, M. 'The bank that broke Spain'. *The Financial Times* (2012)

What does this mean for Scotland?

Creating a banking system which learns from other countries and suits the needs of Scotland's citizens and enterprises will require significant changes at national, regional and local level.

National Investment Banks can play a key role in financing investment in infrastructure and can create positive returns on these investments, helping long-term fiscal sustainability.

Successful national investment banks tend to rely on a vibrant local, regional or municipal banking sector to distribute loans. This is particularly important in ensuring that capital is spread evenly throughout the country, or targeted particularly at regions that suffer from under-investment or deprivation. As Scotland does not currently have such a sector, this would have to be developed in tandem with a National Investment Bank to ensure maximum social and financial returns.

Local, regional and municipal 'stakeholder banks' in other developed countries add economic value by filling the gaps where commercial banks are unwilling to go, providing patient capital, relationships with small businesses, serving the financially excluded, and maintaining a presence in remote rural areas. They also appear to have a positive impact on financial stability. This should be a key aim of any new banking system in Scotland.

Scotland would need to call for supportive regulation to ensure the success of a new banking system. The regulation would seek to preserve the distinctiveness of stakeholder banks, and enable collaboration in networks to achieve economies of scale and pool risks.

Banking for the Common Good: a practical proposal

Using the key lessons from existing alternative banking models and systems, we put forward a series of reforms that can transform the way banking works in Scotland and bring about a banking system that operates for the common good.

We start from the bottom up, sketching out what banking should look like for people, councils and businesses, in order to expand our collective imagination as to the crucial question of ‘what is banking for?’ If we can debate and imagine a better banking system, then we can identify a path from where we are – a highly concentrated and unstable system – to where we want to be – a sustainable and stable banking ecosystem.

We’re going to envision where we want to get to in the section on People’s Banks; before showing in Banking infrastructure as a public good how we can overcome some of the structural barriers; with financing provided through the creation of a Scottish National Investment Bank described in the final section.

The barriers that hold back a blossoming of alternative finance and banking providers at present are high, but we believe they are surmountable with political will and a momentum for change.

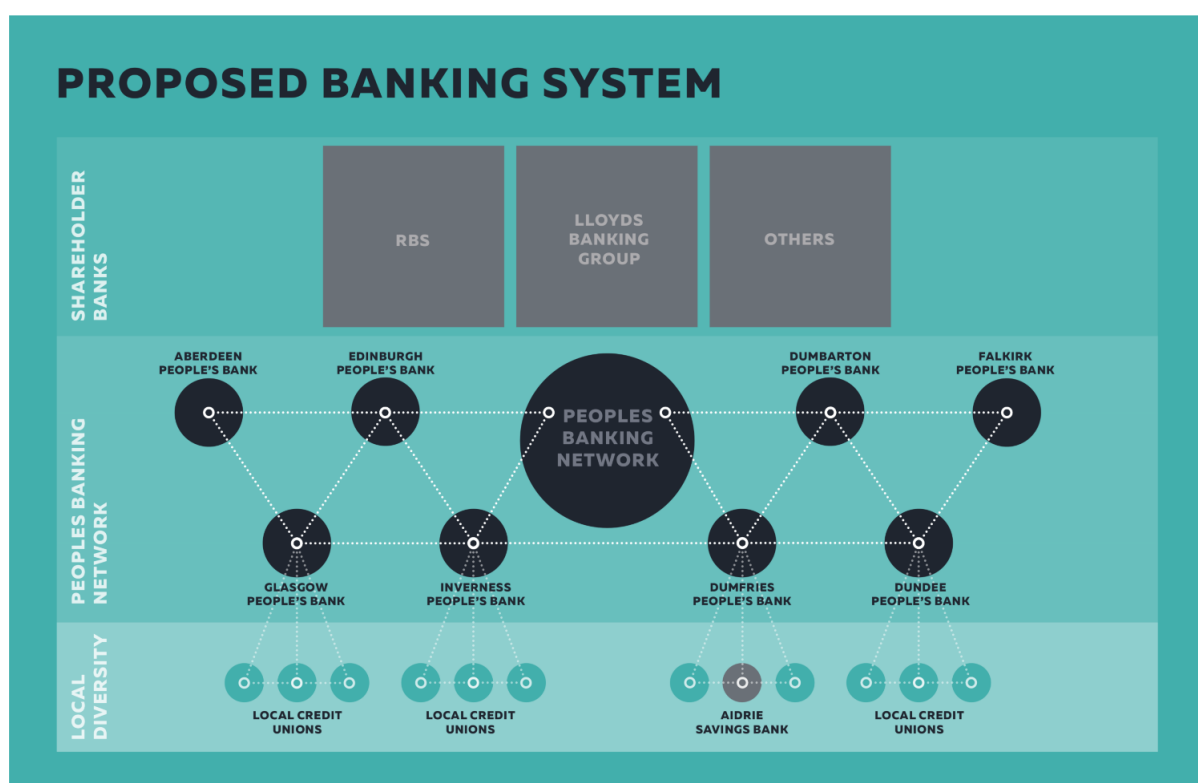


Figure H: A new banking system for Scotland

People's Banks

Building a diverse, resilient and responsive local banking network that sits within a larger banking ecosystem is at the core of our proposal.

Introducing public and co-operative ownership into the system will add resilience and allow for local banking which can underpin smaller businesses and local communities.

We seek the creation of not-for-profit, locally-based banks, *People's Banks*, run in the interests of local communities and capitalised by local authorities, local businesses, credit unions and citizens.

Ownership

The concept of People's Banks is based upon the German local banking *Sparkassen*, where banks are owned locally and mandated to support economic development exclusively within their region and to provide subsidised loans to socially high priority investments.

The banks could be set up by local groups working in collaboration with local authorities, credit unions, existing local finance providers and housing associations. They would seek to use new banking powers to support pre-existing financial diversity (credit unions, local banks) and to extend banking services into areas lacking provision, making decisions based on the needs and strengths of their localities.

The People's Banks would be managed by finance professionals, accountable to a board of trustees made up of stakeholders including representatives of bank workers, civil society, local employers, local government and national investment bodies. Some of these positions should be elected to ensure the democratic accountability of the executive and board.

Local investment

People's Banks would seek to ensure that their banking activities generate enough profit to run the bank in the long-term. However, unlike private shareholder-owned banks, they would also be tasked with working for the public good based on local need, enabling the public interest to form part of the decision-making process. Profits made from more commercially-focused activities (for example loans) would be re-invested into the bank, subsidising less profitable but socially-useful lending, such as social housing, home energy insulation, or start-up funding for SMEs.

Community-based and regionally located, People's Banks would develop specific expertise and knowledge about local investment opportunities and community needs. This would

enable sound decisions to be made about creditworthiness, based on more accurate data than solely relying on the current system of aggregated computerised credit scoring.

Local bank staff would be able to get to know their customers and would be empowered to make decisions using their skill and expertise, rather than acting as customer service agents following a script. Due to the fact that banks would confine their business within specified geographic areas, money will stay within and circulate in the local area, increasing the overall financial well-being and resilience of those areas.

Levelling the regulatory playing field

Deregulation of the banking sector by UK governments since the 1970s has reduced diversity in the ownership models of banks resulting in the current monoculture of very large, universal, shareholder-owned institutions⁸⁴.

Barriers to setting up a bank are high. This has been recognised officially and the regulator has recently relaxed some of its previously onerous capitalisation requirements, with the Bank of England also founding a 'new bank start-up unit'⁸⁵. However, the barriers also include access to inter-bank payment systems⁸⁶. These are owned by the large existing institutions and it has been noted that there is a possible conflict of interest here. Progress in making access to these systems cheaper and simpler for new start-ups appears to be slow⁸⁷ (*see page 19*).

A reorientation towards banking in the public interest requires that such barriers should be reduced. Banking regulation in the UK should be redesigned to account for the lower risk profiles and social benefits of stakeholder banks.

The regulatory burden should fall on a national network to share risk and enable economies of scale, with the People's Banks following guidance and reporting to ensure compliance. How such a network could be created is addressed in the following section.

⁸⁴ Greenham, T. Prieg, L. 'Reforming RBS: Local Banking for the Public Good', *New Economics Foundation* (2015) Available at: <http://www.neweconomics.org/publications/entry/reforming-rbs>

⁸⁵ Bank of England, 'New Bank Start Up Unit' website:
<http://www.bankofengland.co.uk/pr/nbsu/Pages/default.aspx>

⁸⁶ H.M.Treasury, 'Opening Up Payments' (2013) Available at:
<https://www.gov.uk/government/consultations/opening-up-uk-payments>

⁸⁷ Payment Systems Regulator, 'Access and governance of payment systems: the operator's progress and areas of ongoing focus' (2015)

A People's Banking Network

Building a healthy banking ecosystem is not an easy task, but it is a necessary one. Working together, local banks would form a national People's Banking Network that would enable the sharing of risk and reward by working co-operatively to achieve economies of scale, putting them in the best position to plan strategically for both the short and long term.

A People's Banking Network would provide local banks with common branding and marketing, strategic development, training and best practice as well as running vital IT infrastructure and payments systems.

Payment systems, the infrastructure which enables the electronic flow of money in the economy, are primarily owned and controlled by the biggest banks, giving them the power to decide who gets access to payment systems, and at what cost.

A People's Banking Network could run an alternative payments system as a public utility. The accounts and related payments of People's Bank customers could be made through this public payment utility for free or at a low cost.

A new, publicly owned payments system could take advantage of innovative technology, utilising the expertise of Scotland's universities and technology companies. It would be secure and free for account holders, with costs subsidised by charging banks access. Costs would be transparent and only as much as is needed to cover operation and development costs.

Finding the investment to set up the People's Banks and the People's Banking Network infrastructure is clearly a major challenge that must be overcome, and we believe that taking into account the current political constraints one way this could be achieved is through the creation of a national investment bank.

A Scottish National Investment Bank

We believe that the creation of a publicly owned Scottish National Investment Bank (SNIB)⁸⁸ could unlock the investment needed for our future prosperity and environmental sustainability.

The bank should be publicly owned by the Scottish Government and Local Authorities, who would invest in the bank for the benefit of local communities.

It would be regulated as a national investment bank, and therefore would be able to make loans and enable the crowding in of private money alongside public investment to increase the impact of local and national government policy, as well as funding and directing the national system of People's Banks and their inter-bank network.

Its investment policy would provide additionality⁸⁹, offering investment where private banks are unwilling or unable to go. A focus on socially and environmentally beneficial projects will create jobs in Scotland and rebuild a banking infrastructure that serves the public interest.

Such an institution can be created within the current devolved settlement. One institutional model could be to build the bank upon the foundations of the existing Scottish Investment Bank – increasing its mandate and powers, enabling it to function as a full public investment body.

Mandate

The mandate of the bank would be developed through a democratic process, controlled by the Scottish Government, and reviewed periodically.

The bank would however be organisationally independent in following that mandate, to ensure that it makes sound, long-term decisions, free of day-to-day political interference.

⁸⁸ Many thanks to Iain Cairns whose work with Common Weal has been invaluable in developing these proposals.

⁸⁹ Additionality is a key concept for a national investment bank and ensures that the bank provides services or added value where the current provision is unable or unwilling to invest. See Robert Skidelsky, Felix Martin, and Christian Westerlind Wigstrom (2011) 'Blueprint for a British Investment Bank', Available at:

<http://globalstudies.org.uk/wp-content/uploads/2013/01/Blueprint-for-a-British-Investment-Bank-ebook1.pdf>

An example of such a mandate can be found in the European Investment Bank's policy objectives:

○ *To promote sustainable development and employment potential* – this most closely resembles the work that Scottish Enterprise already does, and so increased funding would enable them to expand safely into other areas such as loans to SMEs and community groups. The bank would also seek to finance large-scale infrastructure projects that struggle to attract private finance⁹⁰. Low cost loans for public house building could be part of this remit.

○ *To promote economic and social cohesion and a safe, stable economy* – this would provide the SNIB with a remit to support the creation People's Banks (see page 35). It could also look at providing cheap loans to councils to enable a proper programme of social housing construction.

○ *To further environmental sustainability* – this would provide urgently needed resources to the renewable energy sector, who have been struggling in the face of UK-wide policy changes which deter private investment, and would in particular look to help local councils and communities access low cost, long-term funding for community energy generation and housing energy efficiency retrofitting.

Whilst this mandate is wide, the Bank should not be seen as an endless pot of money for all purposes, but it should instead seek to concentrate on offering additionality, filling the gaps where the private sector is unwilling or unable to tread.

Structure

The Scottish Government, with the financial constraints it has, would be unable to fully fund all of the SNIB's activities, which means that the bank would need to be able to leverage funds and be able to issue bonds to fund its long-term lending and programmes.

⁹⁰ Skidelsky et al argue in their proposal that “the Bank's infrastructure involvement can be characterised as an inverted form of the Private Finance Initiative (PFI). Instead of the private sector raising expensive capital to build assets which it then leases to the public sector, the public sector raises cheap capital to build assets which it then refinances into the private sector” (‘Blueprint for a British Investment Bank’, p 21). We do not find it necessary or desirable to refinance into the private sector, and should instead aim to hold the asset as a public good, reaping long-term revenue which can finance bond repayments and the overall stability of the bank and public finances.

The independence of the bank in its daily decision-making is crucial to attracting dormant private capital and to ensure that the bank is able to achieve high safety ratings with the credit ratings agencies, which will be crucial to its success.

The SNIB could build on the foundations of the Scottish Investment Bank, which is technically an investment arm of Scottish Enterprise rather than a functioning bank, but which has vast expertise about the needs of the SME sector and already holds equity stakes in many promising Scottish businesses. If this is not possible, then the Scottish Government could establish the SNIB as an institution in its own right.

This report doesn't seek to prescribe the exact operational model of the bank. The model should be developed through consultation with existing public finance institutions as well as wider stakeholders. Some options for the bank's legal structure could be:

A 100% Scottish Government owned bank with a public mandate, but with full operational independence.

A government established 'special purpose vehicle', government owned and guaranteed, but acting independently as a stand-alone business re-investing all profits back into the bank and ring-fencing risk from the wider public sector. The Scottish Government would be the major shareholder, but public pension schemes and possibly other financial institutions like credit unions could be smaller shareholders⁹¹.

Capitalisation

The SNIB would need significant volumes of capital to make it transformational to the Scottish economy. Such funds are currently tightly limited, but an SNIB could leverage currently available funds by following the capitalisation models of the European Investment Bank and the Nordic Investment Bank.

In both of these models, the member countries 'subscribe' (guarantee) an amount to the bank, which underwrites the bank's activities, but the amount of capital paid in to the bank is significantly smaller. The bank is then able to raise 2.5 times the amount subscribed through borrowing. Using the European Investment Bank capitalisation model would mean that the Scottish Government could fund the SNIB within the parameters of its existing capital

⁹¹ We recognise that there are severe constraints on local authorities, however there is a lot of money in pension funds which at the moment are invested in fossil fuels and other destructive businesses which we believe, with the correct SNIB funds, could instead be invested into local areas' medium to long-term infrastructure and local business investments.

budget, while ensuring that the bank can start with a capital base big enough for it to immediately make a serious contribution to the Scottish economy⁹².

The Scottish Government's capital budget is set to grow by 5 per cent in real terms from £3 billion to £3.2 billion by 2019/20. In addition, it now has powers to borrow up to 15% of the total capital budget plus Financial Transactions⁹³. In total, £3.63 billion will be available for capital spend in 2016/17.⁹⁴

If only £225m (6.5%) of the Scottish Government's capital budget was set aside as 'paid-in' capital for the SNIB for six years and that accumulated figure was 'subscribed', the bank would have a total subscribed capital of £1.35 billion. That subscribed figure could then (like the NIB and EIB) be leveraged at a ratio of 1:2.5, raising £3.37 billion of available capital for SNIB loans from year one.

To put the size of an SNIB capitalised on this basis into context, the KfW investment bank in Germany, which is the fifth-largest capital issuer in Europe, has raised capital worth 2.6% of German GDP. If the SNIB sourced funds to the same percentage of GDP in Scotland it would be worth between £3.2 billion to £3.7 billion.⁹⁵ Therefore a bank able to raise funds worth £3.37 billion would be a formidable financial institution in the context of the Scottish economy.

The SNIB could raise further capital by establishing bonds for private and pension fund investment. Backed by the Scottish Government these bonds would be considered a highly secure investment. This would enable the SNIB to fund long-term programmes of work at low borrowing rates. The current Scottish Investment Bank is a small scale example of how this could work; it received £30m in direct funding from the Scottish Government, and a further £60m in private and pension fund investment.

⁹² "The European Investment Bank, for example, is set to finance investments worth at least €315 billion (£222 billion) by 2017 with a fiscal outlay of €21 billion" says Skidelsky, R. 'Why we should take Corbynomics seriously', *The Guardian* (2015)

⁹³ i.e. the Barnett Consequentials from UK Government housing related equity/loan financing schemes.

⁹⁴ Scottish Government, 'Draft Budget 2016-17', p.9. Available at:

http://www.scottish.parliament.uk/ResearchBriefingsAndFactsheets/S4/SB_15-86_Scottish_Government_Draft_Budget_2016-17_briefing.pdf

⁹⁵ Common Weal, 'Investment in Scotland: A Common Weal Approach', p.29 (2014) Available at:

<http://allofusfirst.org/tasks/render/file/?fileID=E9A19C8B-50AA-4C42-B1A956BBFD1A0BB7>

The Scottish local government pension scheme, with its assets of some £28 billion⁹⁶, may be interested in providing significant backing to a new SNIB, which would amount to a reliable and steady-performing long-term investment to rival government bond holdings. There is political appetite for this move: during 2015 the Scottish Parliament was investigating ways that local government pension funds could invest more in Scottish infrastructure⁹⁷. In addition, pension funds' boards are staffed by employers, councillors and trade union representatives; natural allies of the People's Banks and Network. As an example of the money available to move towards socially useful investments through the SNIB, a recent study found that Scottish local government pensions had an estimated £1.7 billion invested in global fossil fuels equities⁹⁸.

Our recommendations

The reform and restructuring of the banking sector is unfinished business. The current structures, practices and patterns of ownership are failing to deliver the investments, lending and quality of customer service which Scotland needs; and continue to contribute to many of the problems faced by our governments and people.

All the same, the conventional view appears to be that since banking regulation and macroeconomic policy are essentially the prerogative of the UK government, there is little that the Scottish Government, and other institutions like local authorities, can do about it.

We disagree. In this report we have examined the changes needed and propose radical changes at three levels: enabling the creation of People's Banks; a People's Banking Network and publicly-owned payments infrastructure; and a Scottish National Investment Bank.

⁹⁶ Government Actuary's Department, 'Local Government Pension Scheme (Scotland) Actuarial valuation as at 31 March 2014', p.15 (2014) Available at:

<http://www.sppa.gov.uk/Documents/Local%20Government/Useful%20Resources/Valuations/Actuarial%20Valuation%20Report.pdf>

⁹⁷ Scottish Parliament, 'Investment in local infrastructure projects vital, says Committee' (2015) Available at:

<http://www.scottish.parliament.uk/newsandmediacentre/94371.aspx>

⁹⁸ Platform, 350.org, Community Reinvest, Friends of the Earth, Friends of the Earth Scotland, 'Local Government, Fossil Fuels & the Transition to a New Economy' (2015) Available at: http://www.foe-scotland.org.uk/sites/www.foe-scotland.org.uk/files/Council_Pensions_Divest-Reinvest_briefing.pdf

We have concluded that there are options for moving towards this different banking ecosystem if the powers which already exist are used boldly.

Nothing proposed here is new in itself – we draw on models which exist and form the mainstream within other countries; and in some respects used to exist in the UK. That is what gives us confidence to propose that they should be taken seriously by the Scottish Government, not as a blueprint, but as a direction of travel. With the knowledge and expertise within government, the finance sector and civil society we should be able to have a healthy and ambitious discussion to find the best ways of taking forward the transformation of the Scottish banking sector in order to better serve the needs and aspirations of Scotland.

Our recommendations are:

1. Political parties should discuss and endorse the implementation of our model for banking for the common good.
2. The Scottish Government should convene a taskforce to examine these proposals in greater depth, bringing in a wide range of stakeholders to include Scottish Enterprise, the economic development agencies, existing local and municipal banking institutions, credit unions, civil society groups with specific banking expertise, and local authorities.
3. The taskforce should commission, where relevant, legal and regulatory advice on the practicality and workability of establishing a Scottish National Investment Bank which would enable the creation of banking for the common good in Scotland.

Further Reading

Friends of the Earth Scotland, 2014, 'Smaller, greener banking: Banking for sustainability in a new Scotland'

Download from <http://www.foe-scotland.org.uk/smaller-greener-banking-report>

Cairns, Cooper and Morgan, 2014, 'Investment in Scotland: A Common Weal Approach'

Download from <http://www.allofusfirst.org/library/investment-in-scotland-a-common-weal-approach-2014>

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New Economics Foundation, 2013, 'Stakeholder banks: Benefits of banking diversity'

Download from <http://www.neweconomics.org/publications/entry/stakeholder-banks>

New Economics Foundation, 2015, 'Reforming RBS: Local banking for the public good'

Download from <http://www.neweconomics.org/publications/entry/reforming-rbs>

Skidelsky et al., 2011, 'Blueprint for a British Investment Bank'

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