



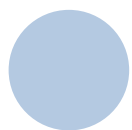
I.O.U.K.

Banking failure and how to build a fit financial sector

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We aim to improve quality of life by promoting innovative solutions that challenge mainstream thinking on economic, environmental and social issues. We work in partnership and put people and the planet first.

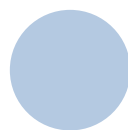
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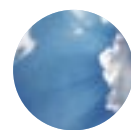
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nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.



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Executive Summary

'It's completely unacceptable to the Government and to business in this country for banks indefinitely to stop functioning as banks.'

Lord Mandelson

Secretary of State for Business, Enterprise and Regulatory Reform

Our banks have ceased to fulfil their original function. Once they thrived on the business of ordinary people and businesses; now they are so big and remote that that basic service is a sideline. They have neglected and undermined the small shops and local enterprises that create most jobs and help provide the social glue that holds communities together. And it's set to get worse. Branches are still closing; those that remain have no local managers and deal with loan applications on the basis of abstract national and regional formulae. The shift in the shape and business model of banks over the last generation has not just precipitated the present financial crisis but has rendered banks 'unfit for purpose'.

Yet a financial system that is fit for purpose can be created by returning the banks to scale, investing in communities and supporting small businesses. Now is the opportunity. The sleeping architecture for a new, resilient economy exists.

However much the marketing campaigns of the banks extol their local virtue, the harsh truth is that they have, without exception, withdrawn from their place in the heart of the community. In doing so, they have played a role in the hollowing out of local economies and communities. They have systematically withdrawn small business services. In fact, the evidence suggests that access to appropriate credit has been increasingly denied to small companies, individuals and social enterprises for, at the very least, the last decade. Banks have closed thousands of branches in the name of efficiency, with dire consequences for local economies, a phenomenon **nef** (the new economics foundation) documented as far back as 2002 in our first *Ghost Town Britain* report.¹ Small and medium-sized enterprises (SMEs) account for a major proportion of UK jobs, and are vital to our economic resilience during turbulent times.

As the impact of the financial crisis begins to play out in full, the scale of the potential implications for the real economy is becoming clear. Jobs are under threat, investment levels are falling and businesses' confidence is plummeting. The media have focused on the thousands of job cuts being made by big corporations, but it is small businesses that account for the majority of private sector jobs: 59.2% in 2007, around 13.5 million jobs overall.² The Government has announced a raft of measures and billions of pounds in support for small businesses. This includes £1 billion in a Small Business Finance Scheme, an-

other £1 billion for small exporters and a further £4 billion from the European Investment Bank (EIB). Yet, the vast majority of these funds are being entrusted to the very banks whose exodus from the high street has so clearly failed the dynamic small businesses that hold our economies together.

While the banks flooded our economy with inappropriate credit, islands of disadvantage were undergoing a drought. This meant that those living in areas poorly served by mainstream finance were forced to develop and build alternative methods of saving, exchanging and lending.

Innovative organisations have been working on the frontline of financial exclusion to develop practical solutions to the consequences of banks' neglect for well over a decade. Community finance, modelled on microfinance – the provision of very small loans the banks deemed too small to concern themselves with – was a key part of the Government's social exclusion policy as far back as 2000. The Social Investment Task Force (SITF) set out to create the conditions for a vibrant, entrepreneurial community development sector by supporting community development finance institutions (CDFIs). These institutions seek to provide the financial irrigation that enables a myriad of small enterprises to survive in spite of banks' neglect.

The Government's myopic obsession with big finance has been demonstrated by the contrast between its measures and President Obama's stimulus package, which included \$100 million to community finance institutions including banks, credit unions, social venture capital and community banks. In response to the financial crisis, the UK Government has bailed out the biggest banks to the tune of £37 billion. CDFIs, however, have received relatively little government support, despite the important role they have played in tackling social and economic challenges of disadvantaged communities. But even without coordinated government support, CDFIs have grown to form a vital element of the sleeping architecture of a more diverse and resilient financial system. With investment, it has the potential to play a far more significant role in local economic development.

To date, the Government's response to the crisis has been preoccupied with a return to 'business as usual'. Yet to do so would leave the fundamental causes of the crisis unaddressed, meaning that we store another, bigger problem for the future. The current state of flux offers a unique opportunity to rebuild a fundamentally different financial system. One that is fit for purpose. There are several ways in which we could act now to build a financial system that will enable us to better weather the coming economic storm, and in doing so will enable us to rise out of the ashes of the crash with a more resilient financial system.

1. Demerge big banks that are now 'too big to fail'.

Large banking and finance groups should be forcibly demerged to create a more varied marketplace of big and small providers with a variety of functions. Consolidation should stop. Retail banking should be split from corporate finance (merchant banking) and from securities dealing.

2. Re-write the Enterprise Finance Guarantee (EFG) to open up lending to small firms.

The EFG, which replaces the Government's Small Firms Guarantee scheme, was intended to kickstart lending but is skewed towards big bank lending to large companies, squeezing out small enterprises and local lenders. The terms of the EFG need to be changed: its bad debt claim limit (which bars lenders that write off too much debt) should be raised from 10% to 20% at least and the proportion of a loan that is guaranteed should be temporarily raised to 90%.

3. Bring in a Community Reinvestment Act to bring the community finance sector to maturity.

The UK needs legislation, along the lines of the United States' Community Reinvestment Act, to oblige big banks and other financial institutions to work in partnership with community finance organisations to increase financial inclusion and to provide financial and infrastructural support for CDFIs.

4. Launch a 'People's Bank' accessible through the post office branch network.

The Post Office should be grown into a national banking system that delivers stable, accessible and dependable services to the public and businesses, following the example of post office banks in Italy and New Zealand. The People's Bank would provide the financially excluded with Visa-embossed debit card accounts to tackle financial exclusion, such as those which have been so successful in South Africa.

5. Require banks to disclose their patterns of lending in disadvantaged areas.

The UK needs to legislate for compulsory disclosure by financial institutions of lending and investment in disadvantaged areas, as a means of tracking performance and stimulating the flow of finance to communities in need of redevelopment.

6. Set up a grant fund, backed by measures to attract private investors, to provide community development finance.

CDFIs need a grant fund for long-term public support to maximise their ability to leverage private finance, improve lending practices and enhance technical capability. Many third sector institutions will require ongoing grant funding to carry out the activities that have the most social benefit to individuals and their communities.

A 'sleeping architecture' of the new economy already exists, in initiatives like credit unions, community finance and local enterprise schemes. They have been operating on the front line of the old economic order, but they need support. As the Government has taken unprecedented action to bail out the biggest banks, it must also act to strengthen and underpin the small, local organisations valiantly shoring up our local economies and communities. If we are to rebuild a more resilient financial system, they must be nurtured and embedded into public policy to complement the existing banking infrastructure. The future of our local economies and communities depends on it.

Introduction

'We must continue to encourage banks to lend. Having recapitalised the banks, we must ensure that the money is used to sustain credit lines on normal terms to solvent businesses.'

Gordon Brown

30 October 2008

Having taken significant controlling stakes in major high street banks, the Treasury issued a statement saying that the banks had promised to maintain the availability and active marketing of competitively priced lending to homeowners and to small businesses at 2007 levels. On 13 October, the Chancellor of the Exchequer, Alistair Darling, said this had been misunderstood; it only referred to the particular banks he had offered funding to.

Then, in a ground-breaking change from decades of cross-party economic orthodoxy, in his 2008 pre-budget report, the Chancellor ripped up public borrowing rules and implemented a plan for fiscal stimulus which highlights small businesses as a crucial component of recovery. The Chancellor identified the need to improve the availability of finance for small and medium-sized enterprises (SMEs) as a key challenge created by the crisis of confidence in banks and their lending.

UK government policy has had to change quickly and flexibly now that most of the nation's banks are effectively in public ownership. Without government funds these banks would be unable to trade. This situation offers a unique opportunity to reshape the financial system so that it is fit for purpose.

A central element of the process was the increasing consolidation of the banking sector, which did not elicit any Government disapproval at the time. As institutions ceased to specialise, they converged on the most profitable activities. This meant that less profitable activities, such as maintaining a branch network and relationships with small businesses, were neglected.

That is why the rules on lending are important. The original announcement was an admission that there was a danger, at least, that the banks would concentrate so much on their own survival and return to independence that they would neglect their real purpose: lending. The Treasury's statement was also at least a tacit confirmation of the distinction between the real economy of goods, services and local economies and the unreal economy of merger fees and speculation, on which so many banks have concentrated.

This report looks at the banks after their effective nationalisation. It looks at their failure – not just now, but before the so-called credit crunch – to provide the right services and loans to local economies, which need that support in order to survive. It looks at whether the Treasury's promise on returning lending to 2007 levels is likely to be enough. It also looks ahead to future policy

responses, and what we can do to make sure Britain's recovery from the recession is fast and underpinned by the vital small enterprise that makes the difference between national success and failure.

Section 1: The problem

‘The question is not “are people credit-worthy?” but “are banks people-worthy?”’

Muhammed Yunus
Grameen Bank, 1976

In 2003, **nef**'s *Real World Economic Outlook* warned that: 'Removing controls over the finance sector paved the way for its rise to dominance... Financial institutions, we contend, no longer act as servants to the real economy but as its masters...'³

It also predicted: 'There will be a collapse in the credit system in the rich world, led by the United States, leading to soaring personal and corporate bankruptcies... [in which case] the probability of a financial crisis rises appreciably.'⁴

The deeper problem is that, in pursuit of those speculative profits, our banks have ceased to fulfil their original function. They have transformed themselves from institutions that thrived on the business of ordinary people and businesses – where they retained a hallowed, slightly awe-inspiring corner of probity and advice on the average high street – to institutions where that basic service is a sideline. Local branches are still closing; those that remain have no local managers and deal with loan applications on the basis of national and regional formulae.

The argument of this report is that this shift in the shape and business model of banks over the last generation has not just caused the present financial crisis, but renders banks 'unfit for purpose' when it comes to financing the local economy. In fact, the evidence suggests that access to appropriate credit has been denied to small companies, individuals and social enterprises for at least a decade, while the financial sector grew.

While British banks were growing into titans that thought they could rule the world, a financial drought has been occurring throughout Britain's disadvantaged communities for more than a decade. This has pushed the financially vulnerable to predatory lenders and loan sharks, forced small businesses to rely excessively on personal and credit card debt, and robbed our communities of the bedrock of a thriving local economy. In addition, for some businesses, it has been a credit crunch decade while, perversely, personal credit growth exploded.

The widening financial crisis is now making this situation worse. There is already evidence that banks are cutting back on help for small, high street enterprises, which employ 13.5 million people in the UK⁵ and will be the sector that drags the nation out of recession. While all attention remains on the financial behemoths, the real economy they should have been supporting is not just being neglected; it is in danger of being starved of the basic banking functions that are prerequisites of an economic recovery.

The importance of access to finance for an enterprise economy

The impact of the closure of bank branches on local economies has been well-known for some time. The closure of a bank branch is often the tipping point at which the economy of a high street goes into terminal decline, a phenomenon identified in the 2002 **nef** report, *Ghost Town Britain*.⁶ Closures have also had a disproportionate impact on more disadvantaged areas.

Bank closures can be seen partly as a response to new technology: more customers now do their banking online, although the queues at the remaining branches suggest there is a continuing need for face-to-face banking. But closures are also made possible by the disastrous conversion of the mutual sector into banks and by the over-consolidation of the UK banking system.

This consolidation began in the 1960s as a way of extending geographical and marketing reach. The merger of the National Provincial, District and Westminster banks created a network of over 3,000 branches. The then new National Westminster Bank (since subsumed into the Royal Bank of Scotland Group) was launched with an advertising campaign with the slogan 'Our roots are our branches'. According to the Campaign for Community Banking, 2,737 bank branches have closed in the last ten years. In December 2007 there were 10,131 retail bank branches, including 2060 former building society branches.⁷

Bank closures have caused major local problems. When Barclays bought the Woolwich Building Society, it led to a wave of branch closures and loss of choice. Other consolidation had the same effect. This has an enormous impact on the small business sector. Studies show that surrounding shops can lose between 20 and 30 per cent of their turnover when the local bank closes. Small businesses, 90 per cent⁸ of which have accounts with the traditional high street banks, are also forced into long journeys to deposit their takings.

But the most important impact is on access to debt finance. Small businesses have diverse requirements, which could be understood by local bank managers. They cannot be understood by the centralised formulae by which banks now decide funding. The result is that small enterprise is increasingly starved of the finance it needs.

Locally embedded alternatives have emerged to address this failure and the gap in the market, but have received little policy support, in part because the financial sector *appeared* to be in good health. **nef** helped pioneer one of these efforts: the community development finance movement. Community finance is a form of microfinance aimed principally at supporting enterprise and economic development, as well as combating personal financial exclusion. In 2000, Community development finance institutions (CDFIs) designed to support small enterprise received government backing of over £50 million⁹ to partly implement the recommendations of the SITF. They were, and remain, a policy tool of national, regional and local government; as well as independent lenders who happen to deal with social challenges. Government money was provided to support CDFIs' enterprise lending to companies and individuals who had been refused credit by banks. Government soon recognised that this was a long-term policy commitment, and had intended the Phoenix Fund, which distributed financial support, as a pilot shaping its long-term support. Instead, the funding and policy support has dwindled and been devolved to

Regional Development Agencies (RDAs) with mixed results.

In spite of the lack of support, the sector has grown to lend over £285 million in 2007, including personal lending and social enterprise. CDFIs in the UK have grown to serve not only businesses and social enterprises that were excluded from finance altogether, but also those who could not obtain their full financing needs from banks.

The motor of recovery

In the coming recession, support to small business will become especially important. Weathering the recession will rely on the ability of small companies and local communities to withstand the economic storm, despite the slowdown in bank lending.

Even before the current crisis, the drive to maximise profits has meant that banks neglected relatively low-margin activities, such as small loans or basic bank accounts. Banks are reluctant to finance very small businesses given the high transaction costs of appraising and securing such loans. The headline rates offered in banks' shop windows were not easily accessed by start-up companies and new entrepreneurs; they sometimes faced rates of up to 19% or more offered by banks reluctant to lend to this sector, according to mounting evidence from small businesses' input into the Department of Business, Enterprise and Regulatory Reform and Regional Development Agency (RDA) consultations.

Banks increasingly started to use credit-scoring techniques. This encouraged people to borrow personally rather than through the business lending arm. Customers thought to be risky, such as those based in deprived areas, were more likely to be denied credit. Not only do banks charge more to lend in deprived areas, they also started to systematically withdraw from these poorer neighbourhoods. Many SMEs have relied on personal credit to keep their businesses going, but running up credit card debt is a precarious way of running a small business. It also leaves businesses without the critical service once provided by local bank managers: business advice and support.

But now the crisis has arrived, there is mounting evidence that banks, having been bailed out by taxpayers, are seeking to return to profitability at the expense of the small business sector, abruptly cancelling overdraft agreements, refusing loans for expansion, and using nationwide formulae to make decisions that are clearly local matters which depend on details and personalities that the formulae are unable to capture. The November 2008 *Confederation of British Industry Survey* reveals a worrying picture. It found that three quarters of companies are facing more stringent borrowing conditions. A third of businesses say that existing lines of credit have been reduced or withdrawn completely. The report notes that these impacts are felt more acutely in precisely those areas where small businesses are most reliant on banks: for working capital and investment, rather than mergers and acquisition finance.¹⁰

Recent evidence suggests that the importance of small businesses is increasing relative to larger organisations. The evidence shows that in the last decade larger firms (over 250 employees) have seen their share of employment fall. The decline in jobs amongst those smallest firms has been offset by employ-

ment creation in the small business sector.¹¹

The British Bankers Association has defended the sector by arguing that bank lending to small businesses was up 9 per cent in October on the same month a year before. That would imply that the banks are heeding the pressure from the Government: indeed, it has been taken as evidence that they are doing so. The truth is that this figure is misleading, for three reasons. First, the credit crunch was well under way by October 2007. In fact, almost the only entities that were aware of the scale of the problem at that time were the banks. Autumn 2007 marked the nadir of bank lending as banks realised their own perilous condition. Secondly, the problem is broader than loans to small business. The 9 per cent figure takes no account of the conditions of the loans, which are overwhelmingly tighter and more stringent than before the credit crunch. It also ignores that main problem faced by small businesses today, which is the withdrawal of their overdraft facilities effectively reducing the credit available to them. Thirdly, banks are no longer structured to lend to small enterprise. Banks are not failing in their duty to support enterprise because they are somehow selfish, or too uncertain in the current climate; our argument is that they are no longer structured to do so – and this was true in the boom years just as it is true now.

Despite the British Banking Association's claim that banks are continuing to lend,¹² there was some confirmation that the banks were reluctant to play their role in kick-starting the economy when, on 30 October, Alistair Darling pressed the banks to change their voluntary code on lending to small businesses. The Chancellor admitted that the Government was powerless to dictate the amounts or terms the banks offered the sector.

The Chancellor's admission is also a tacit acceptance that Gordon Brown's assurance of support for small companies as a condition of the £37 billion recapitalisation of Royal Bank of Scotland, Lloyds TSB and HBOS was meaningless. The announcement by Alistair Darling in the pre-budget report of his planned multibillion-pound boost to small businesses is, as *The Financial Times* described it in advance, an 'admission that the £37-billion bank bailout has so far failed to boost lending to business'.¹³

That same reliance on banks' discretion weakens the efficacy of the £4 billion four-year funding from the EIB which is being channelled through the banks. Once again, there appears to be no means by which the Government can force the banks to make use of this effectively. Worse, given the evidence that the banks lack the infrastructure they need to lend effectively at the local level, all the indications are that this initiative will be ineffective as well.

There is also growing evidence that businesses are cancelling plans to expand or launch because they are under the impression that the funds are not available – precisely the opposite of what ought to be happening in a recession. ART (Aston Reinvestment Trust), a Birmingham-based CDFI, says that potential clients seem to have been discouraged from taking forward their ideas to start or expand their businesses, although ART does have funds to lend.

The wider problem of financial exclusion

The era which saw record banking profits while branches were systematically closed has been a problem for entrepreneurs. It also represents a key challenge to the communities whose lack of financial services impacts virtually every facet of people's daily lives.

About three million of the population are still unbanked.¹⁴ Their savings, such as they are, earn no interest and are not available for re-investment, and the prospects for local enterprise are further undermined. This problem lay behind the UK Government's encouragement of banks to introduce basic transactional accounts open to all, regardless of credit history or income level.

People without bank accounts pay more for services which people with bank accounts receive for free, or at reduced cost. One estimate sets the amount of extra money spent by financially excluded and low-income households at £1,000 per year, resulting from punitive fees and higher charge rates for customers who do not pay via direct debit.¹⁵ British Telecom has introduced a £1.50 fee per month for customers who don't use direct debit, making the service more expensive for people without bank accounts. Charges for fuel pre-pay meters are also higher than for people who pay by direct debit.

The basic bank accounts which were a supposed solution to this problem are not fit for purpose. Banking services are still not universal and the disadvantaged continue to bear the full cost of their exclusion. Under a voluntary banking code, the major banks have little incentive to promote uptake of accounts or to invest in innovative solutions. Low-, and increasingly, medium-income clients are not attractive to banks. Post offices, long-trusted providers of financial services in these communities, are still under threat. As **nef** research has shown, the loss of a post office branch may contribute to a further drop in the quality of life in the community, and lead to a decrease in local spending and economic activity, by around £300,000 a year per ward.

The irony is that there is strong demand for financial products in these areas. HM Treasury research acknowledges that there is a real need for credit and financial inclusion activities, such as debt advice, especially among those segments of the population to which banks refuse to lend. Research carried out by Leeds City Council provides estimates of the extra costs of borrowing from these lenders. The lower-end estimate, assuming that 21,000 people borrow an average of £100 from doorstep lenders at an APR of 177 per cent, shows extra costs of nearly £500,000 per year.¹⁶ The problem would be compounded by the closure of local post offices, which have significant social and economic impacts on local business and communities. The recent award of the Post Office Card Account to the post offices is no more than a reprieve as subsequent announcements regarding part-privatisation have revealed.

Banks have also resisted disclosure of the geographical and social patterns of their deposits and lending practices, which means that geographical exclusion from critical financial services remains a problem in UK financial institutions. In the USA, however, it has been tackled effectively since the 1977 Community Reinvestment Act. Thanks to a later amendment within this Act, over \$800 million have been provided to American CDFIs since 1995. That is the bedrock on which the additional \$100 million in the recent stimulus package will build.

The Act, which created the precedent for banks to work with community groups and social enterprises like CDFIs over thirty years ago, has succeeded in leveraging 27 times more private investment principally from banks and other financial institutions. This money has been invested into some of America's most disadvantaged communities.¹⁷

Further steps are required to build a strong community finance sector that is part of a thriving social investment marketplace, where private financial flows can be channelled to well-managed social and community enterprises that create real and lasting change for disadvantaged neighbourhoods. The conventional banks have played too little role in creating this, so it would be naïve to expect a simple return to 2007 lending levels, as the Chancellor of the Exchequer has called for, to solve the problem.

Quite the reverse: the UK banking sector is now consolidated to the point where it is not well geared to meeting local needs. It is geared instead towards the profits that were available in investment banking and speculative finance. Simply requiring them to return to business as usual will not reconnect finance with the productive economy. The banks have driven the process of channeling finance into unproductive and destabilising investment, while productive investment - the job for which they are supposed to marshal savings - has stagnated. Even if the existing part-nationalisations and bailouts were to succeed, there is no point in restoring the banks' balance sheets so that they can carry on in the destructive way they did before.

Section 2: Infrastructure failure in practice

‘Do you know how long it takes a working man to save five thousand dollars? Just remember this, Mr Potter, that this rabble you’re talking about... they do most of the working and paying and living and dying in this community. Well, is it too much to have them work and pay and live and die in a couple of decent rooms and a bath?’

It’s a Wonderful Life, 1946

The erosion of banking infrastructure in the UK means that our banks are no longer well placed to distribute the productive investment that is their purpose. Their failure to do so leaves the British economy very vulnerable. The stories of Blue Sea Food and ECO-Logic are not just examples of the banking infrastructure letting down a successful business start-up, and a marked contrast to the bailout of those companies which were considerably more indebted; they are also examples of how a parallel banking infrastructure was able to provide support at a critical period.

ECO-Logic: Community finance bridging the gap

ECO-Logic UK supplies cutting-edge, electronically controlled, water-saving systems to large companies and institutions. Its story shows just how our banking sector has failed to support small businesses and entrepreneurs prior to the credit crunch.

Early on in ECO-Logic’s life, it spent years trying to prove to funders that its idea was ahead of its time and water-saving systems were crucial technology for the future. The business took off as customers began to realise the benefits; the company posted a record year in 2006 and planned for growth. But the bank decided it could no longer support ECO-Logic and the company was faced with letting staff go and reducing its marketing.

It was at this stage that ART, a local CDFI, stepped in. ART is an independent, alternative provider of finance to small businesses, lending between £10,000 and £50,000 to businesses in Birmingham and Solihull. Crucially, it lends to businesses that have been unable to get all or part of the finance they need from a bank.

This critical finance did the trick. The Sales & Development Manager, who had not been let go thanks to ART’s loan, succeeded in generating two new orders. As the Company Secretary and Business Manager said, ART successfully ‘bridged the gap’ in financing which ECO-Logic faced from its bank: ‘Without ART we would have had trouble moving the company forward.’ Steve Walker, Chief Executive of ART, commented:

'Our remit is to boost the local economy by helping local companies create or safeguard jobs. ECO-Logic UK is a classic example of what we are here to do. We are able to adopt a more personal approach to lending than the banks.'

Blue Sea Food: CDFIs providing a bailout to business, not bankers

The Blue Sea Food Company is a seafood processing company based in Brixham, South Devon. It is a successful medium-sized business and it demonstrates how the failures of the local banking infrastructure are being played out at a local level. The company buys crabs and supplies to retailers including Sainsbury's and Tesco. It employs 40 full-time staff which can grow to 60 during peak season. The local crab fishermen are totally dependent on Blue Sea Food and the impact of it going under would not just be for those it employs, but for the local economy as well.

The cost of storing off-season stock required a loan. Until a local branch took over the relationship, Blue Sea Food's bank was uninterested in providing any other form of loan. Although the local branch was keen, head office arrived for a 30-minute visit and then refused the loan. To make matters worse, the overdraft facility was cancelled with only three months in which to run it down.

This left over 50 jobs at immediate risk plus 10 fishing boats that are reliant on Blue Sea Food. After the failure of the conventional banking system, a coalition of CDFIs stepped in to provide loans which have kept the company afloat. That coalition provided £150,000 from the Wessex Reinvestment Society (WRS), SWIG (South West Investment Group) and Finance South West. The Chief Executive of WRS, Paul Sander-Jackson, said:

'This is a classic case of the impact of a central lending policy being applied regardless of local circumstances and local consequences. The fallout from the failure of a key anchor business within this – or any other – community would be massive, and the ultimate costs to everyone enormous.'

The importance of this alternative banking infrastructure has been made even more evident recently. Annie Popham, WRS's Investment Manager, explains how this works:

'Trust is built through personal relationships with our customers enabling us to respond when the going gets tough. This relationship has reached new depths lately since the Blue Sea Food Company endured a serious setback through fire at their Paignton premises. We were able to reassure the company of our continued support during this difficult period.'

Failing banking infrastructure

Because they are social enterprises, CDFIs like those featured are not just making their business decisions based on commercial grounds. They also consider the social benefit of helping a business; how many jobs can be created or saved and what that means to a local economy. They are not a parallel banking system, rather a social enterprise solution to where the banking system cannot or will not go.

Part of the problem with the mainstream infrastructure is how little it resembles the kind of local banking that people imagine is still there, with bank managers

who will consider local angles and local individuals. The reality is that most banks have no local managers, though they have individuals assigned at regional level to high-net-worth customers, and their decisions on loans are made according to formulae rather than local knowledge. That was certainly the experience of Blue Sea Food and of ECO-Logic.

In Blue Sea Food's case, WRS, SWIG and Finance South West were nearby and could help. As ECO-Logic found, ART's appreciation for the value of its business not just financially but to the local economy allowed it to continue to grow. Help from CDFIs is increasingly under threat, however. While banks are granted a multibillion-pound bailout, these innovative and genuinely local finance institutions are under-resourced.

Alternative banking infrastructures

Over the past decade, **nef** has helped to introduce CDFIs to the UK as a model for bringing investment into some of our most disadvantaged communities.^{18 19 20} Approximately 80 CDFIs are now established across the country. The sector has achieved a high degree of diversity, ranging from the provision of small personal loans of £50 to social enterprise loans of £1 million. It is active in urban inner cities as well as in remote rural communities. Micro-enterprise is a key market for CDFIs, with half of the organisations focused on this activity.

CDFIs have emerged over the past ten years to provide loans to people and enterprises excluded from mainstream finance. They were designed to create a positive cycle of investment, redevelopment and opportunity for disadvantaged communities by providing much-needed capital.

Our research has found that much more could be done at policy level to support these vital outposts in some of the most disadvantaged communities." This support could focus on helping CDFIs to raise more commercial finance and to grow to a more efficient scale of operation. CDFIs complement the financial system where banks choose not to provide their services. They represent an opportunity to address those gaps in access to finance fostering a partnership between banks, community organisations and social enterprises providing finance, such as CDFIs.

Their existence is also a confirmation of the reality of a 'credit crunch decade'; that the conventional banking infrastructure was failing local economies long before the current crisis. As the Government's efforts to encourage lending demonstrate, banks will not provide the support the nation needs to escape from recession by simply returning to their lending policies of 2007. Perversely, the CDFI sector appears to be suffering from dwindling government support for enterprise lending just when it is needed most. The failure of the sector to realise its full potential lies in the conflicting demands on it: the core functions of CDFIs – outreach and regeneration – cannot be easily reconciled with short-term financial sustainability. The operating practices of CDFIs and the realities faced by the communities they serve mean that they are seeking to generate long-term social benefits, rather than exclusively seeking short-term financial profits.

Banks appear to think that funding investment in local communities is the Gov-

ernment's job, and the Government thinks that CDFIs should find funding for these activities from private investors, such as banks. This leaves CDFIs' vital work balance on a knife-edge. Now that public funds have been reduced, CDFIs could become wholly dependent on income generated from their interest revenue, and on private sector investment, potentially threatening their social outreach. In contrast, banks have been nationalised but refuse to recognise any social obligation to the wider UK economy.

In contrast to central Government, some Regional Development Agencies (RDAs) are taking the initiative and helping CDFIs' lending because the RDAs understand the importance of CDFIs' work to local and regional economies. The Northwest RDA has invested £5 million in a £10 million small business loan scheme that is being administered locally by CDFIs. It also constructively allows banks to contribute, with supporting loans matching the contributions for loans between £3,000 and £30,000.²¹

CDFIs represent only one of several alternatives to relying on banks to revive the economy. CDFIs are too small to fill the funding gap and systematic under-investment that has resulted while banks used their capital to chase ever more speculative super-profits. The merger between Lloyds-TSB and HBOS seems likely to unleash a new wave of local branch closures, as many as one-sixth of the remaining network which will mean – at best – a reduction in choice and competition at local level. Meanwhile, most authorities suggest that the local post office sector – which has just lost thousands of branches – could still suffer from another round of closures.²² Instead of worrying about what banks can afford, we should focus on whether the economy can afford a further blow to its local financial infrastructure.

Section 3: Conclusions

Further consolidation of the banking sector will take bank branch numbers to dangerously low levels below which our local economies could struggle to recover. As this report has identified, the remoteness of our banking infrastructure and the formulae by which loans are granted, or not, to small businesses means that our banks are no longer able to effectively mobilise savings to invest in the myriad of small businesses that drive our productive economy. As the impact of recession is more acutely felt, the pressure for government action to halt job losses and support those hit hardest will grow. If the funds the Government has promised to support small businesses are channelled through the high street banks, they will fail to reach the dynamic small enterprises that drive the productive economy.

This failure to make banks benefit the economy despite taxpayer bailouts is now demonstrably a failure. As the Financial Times reported, the loan scheme implemented by the Government to help banks re-start their lending to solvent and viable businesses has so far failed. Supposedly worth £1 billion in guarantees, in the case of Barclays bank the EFG has so far managed to encourage only £12 million of the £1 billion available to trickle out of the banks' coffers to small businesses.²³

This report has identified a failure of the local banking infrastructure which pre-dates the credit crunch, and in three fundamental ways:

- It has failed to provide access to finance for poorer people.
- It has failed to provide adequate financing to small business.
- It has failed to support innovative social enterprise solutions.

This failure has a number of important implications, including the fundamental one that simply returning to 2007 lending levels is an inadequate measure for what has become an inadequate banking infrastructure. Unless this fundamental infrastructural failing is addressed, the fallout for our local economies, and the wider economy, is likely to be disastrous.

The high street banks have consolidated beyond the point of usefulness to the local economy.

Consolidation in the UK banking sector has reduced the number of regional and local branches. Many banks no longer have a physical presence in low-income areas, making loan application and assessment increasingly difficult for local entrepreneurs. Britain's least affluent inner cities and traditional manufacturing areas have lost more local high street branches than any other area

since 1995. Lack of bank branches has clear negative consequences for low-income customers and local businesses, and it is a result of over-consolidation, too little competition and a shift of the banks' attention away from the needs of their ordinary customers and towards the speculative markets.

Recovery from recession depends on supporting SMEs.

The small enterprise sector has a critical role to play in the UK's economic recovery. SMEs have an estimated combined annual turnover of £1,440 billion and employ an estimated 13.5 million people, 59 per cent of the private sector workforce. They account for 99.9 per cent of all enterprises and 51.5 per cent of private sector turnover.²⁴ The bottom line is that if the banking infrastructure is inadequate for small enterprise, then recovery from recession will be delayed.

The reality of banks' lending in the current climate is that it is unfit for purpose when it comes to supporting economic recovery. Instead the innovations and alternative solutions that include CDFIs and other providers of social finance should be seen as a vital complement to a financial system that is failing key sectors.

Disadvantaged communities are likely to suffer in the recession more than they would otherwise have done.

In 2005/06, 13 million people in the UK lived in households that were below the low-income threshold. This is roughly one-fifth of the population. Poverty is now concentrated in specific geographic areas, where disadvantage is intensified by low skills, joblessness, and underemployment. In 2007, there were 3.6 million people who wanted to be in paid work but were not. These neglected neighbourhoods are characterised by financial deprivation, poor public services, low-quality housing and limited infrastructure. Lack of access to opportunity creates disengagement and apathy. Among the many factors contributing to the decline of disadvantaged neighbourhoods are limited access to finance and lack of appropriate financial training and business support. Financial services institutions often withdraw from low-income communities. Bank branches and post offices close down.

Any policy response to the current crisis is going to have to take these implications into account. Other competitor nations have managed to retain a greater proportion of their local banking infrastructure. The large credit unions of North America and the agricultural banks of northern Europe have no real equivalent in the UK. The most urgent question for UK policy-makers is how and when we can replicate something similar in our local economies.

Section 4: Recommendations

‘To set out how entrepreneurial practices can be applied to obtain higher social and financial returns from social investment, to harness new talents and skills to address economic regeneration and to unleash new sources of private and institutional investment.’

Gordon Brown’s remit for the Social Investment Task Force
February 2000

The irony of the current crisis in local banking infrastructure is that the Government has been aware of the problem for some time, especially where it impacts on the poorest communities.

Policy-makers have focused on enterprise development as a way of narrowing the gap in economic wealth between different regions. RDAs were set up in 1999 to reinvigorate the task of economic development and social and physical regeneration through a business-led approach and several have been key supports of the community finance sector. A range of initiatives were supported, such as CDFIs themselves, the SFLG, regional venture capital funds, and enterprise capital funds were developed to improve access to finance for SMEs. The baffling aspect is the Government’s failure at national and local level and the failure of local bodies to champion these approaches and the successes they’ve had more widely. One of the major factors inhibiting further use of these innovations is that many people remain unaware of the alternatives to the failing mainstream financial sector.

The Government has promoted community finance as one such alternative method of delivering financial inclusion, enterprise-building, and regeneration since 2000. Gordon Brown launched the SITF in February 2000 to encourage private investment in enterprises in deprived communities. Its five-point framework for investment in disadvantaged communities successfully resulted in the establishment of the Community Development Finance Association (cdfa), community investment tax relief, and the Bridges Community Development Venture Capital Fund.

All these measures were tacit recognition that the local banking infrastructure was failing to provide the universal support it needed to. Once again, banks simply returning to their lending patterns of 2007 will make little or no impact on solving a problem which dates back very much further.

The latest stimulus plan

The Government’s 24 November pre-budget report set out a series of measures to improve the availability of finance for SMEs. Yet again, this relied heavily on the mainstream banks that have been so reluctant to reinvest their profits in small business lending and more recently resistant to passing on their

taxpayer-funded bailout to this crucial sector.

As we have seen, the EFG scheme to provide temporary guarantees to enable up to £1 billion of new lending by banks is not succeeding, according to the initial evidence, in its fundamental aim. Replacing the SFLG, it offers loans from £1,000 to £1,000,000 which is far higher than its predecessor's ceiling of £250,000. It allows companies with turnover of up to £25 million to apply and guarantees the lender up to 75% of the value of the loan if it is not repaid.²⁵ This sits alongside the £1 billion from the EIB, which will also be given to banks for the purpose of lending to SMEs.

Though CDFIs are a recognised component of the business simplification scheme of the Department for Business, Enterprise and Regulatory Reform, their capacity to understand local economic conditions and lend in ways that banks simply do not understand any longer is underappreciated by policymakers. The EFG has *reduced* the annual cap for bad loans to 10%. If a lender seeking to use the EFG has a proportion of bad debts above 10%, it can only partially benefit from the scheme. The SFLG had no explicit limit and typically ran at about a 20% bad debt rate according to the Treasury's own review from 2004.²⁶ Tightening these conditions at the start of a recession is wrong-headed. Similarly, the higher lending cap of £1 million will allow banks to continue the mistake of focussing on the larger end of the business spectrum and yet again abandon the small businesses that make up such a significant component of our national and local economies.

We make the following recommendations for the business finance sector and for reform of the wider economy:

Supporting business with appropriate finance

1. *Re-write the Enterprise Finance Guarantee (EFG) to open up lending to small firms.*

The announcement of additional money to encourage finance to SMEs also needs to consider how to make best use of the existing tools that are there; including CDFIs and the current loan guarantee scheme. The Government should expand the EFG scheme which provides guarantees for up to 75 per cent of the value of a loan. It encourages lending to small businesses by sharing some of the risk a lender faces. In case the loan is not repaid, up to 75 per cent of the loan will be paid by the Government. In this way the lender still makes commercial decisions, but is likely to lend more to small firms than otherwise would be the case.

The Government should temporarily extend the upper limit on the guarantee to 90 per cent for the next year to ensure that banks have no excuse to deny small firms the capital they need to survive. It should fast-track the use of the EFG to CDFIs and other innovative business lenders. The Government's own review, *The Graham Review*, encouraged the extension of the old SFLG to other lenders.²⁷ Just six CDFIs received SFLG accreditation.

In the past, a critical obstacle to greater use of these tools has been rules on state aid which have inhibited excessive government support to indus-

tries and sectors to ensure fair competition. In response to changed circumstances, the EU has raised the limit acceptable for such schemes to 90% explicitly in order to allow Governments to respond to the current crisis without violating State Aid rules.²⁸

2. *Bring in a Community Reinvestment Act to bring the community finance sector to maturity and create an effective partnership with the banking sector.*

The UK needs a package of legislation equivalent to the Community Reinvestment Act in the United States. This 1977 Act set a precedent for community finance institutions to partner with banks and financial institutions. In the UK, it was originally envisaged that the banking sector would be a natural ally of CDFIs in terms of funding, investment and referrals; however, strong partnerships are yet to emerge as a norm for the sector. Banks have resisted any compulsion to widen their participation in key areas, and legislation will be required to compel them to co-operate with and invest in third sector finance organisations. The support from banks need not be simply financial, but should include technical *and* financial support to help CDFIs build the required infrastructure to increase the scale and scope of their activities.

3. *Set up a grant fund, backed by measures to attract private investors, to provide community development finance.*

CDFIs need a grant fund for long-term public support to maximise their ability to leverage private finance, improve lending practices and enhance technical capability. Many third sector institutions will require ongoing grant funding to carry out the activities that have the most social benefit to individuals and their communities. This work is often costly and barely profitable, but its benefits to society far exceed the costs. The April 2008 **nef** briefing, *A model for funding and supporting CDFIs: lessons from the United States*, sets out the difference that legislation can make by enabling and requiring banks to partner local lenders.²⁹ According to the latest report of the US Treasury, government money distributed via the CDFI Fund succeeds in leveraging private investment into local lending and investment via CDFIs that is worth 27 times the amount the Government puts in, though that includes significant secured lending, such as for property purchase.³⁰ As noted above, it has disbursed over \$800 million to the sector since 1994 and in addition an extra \$100 million has been released by the financial stimulus bill recently approved by Congress.

The above recommendations provide ways in which the Government can support the community finance sector to address the failings of the financial sector. Of course, the challenges of developing a financial system that serves the wider economy and society is not limited to what can be achieved through community finance and enterprise development.

Banking fit for purpose

Below we set out further recommendations for reform to create a financial sector that returns to being a servant of society, not its master.

1. *Demerge the high street banks.*

Instead of further consolidation, the discredited financial institutions that

have needed so much public money to prop them up during the credit crisis should be reduced to a size whereby their failure would not risk the system itself. We are calling for the forced demerger of large banking and finance groups. Retail banking should be split from both corporate finance (merchant banking) and from securities dealing. The demerged units should then be split into diverse banks addressing different segments of the financial market, which would ensure no one institution could again be 'too big to fail'. In the rush to nationalise and impose 'shotgun weddings' on banks we are storing up worse crises for the future. It took more than 50 years for policy-makers to forget the lessons of the Wall Street Crash of 1929. The Great Depression led to the Glass-Steagall Act in the USA to prevent financial institutions exploiting their market position and power and profiting from conflicts of interest. A truly resilient financial system has a multitude of financial actors, making diverse investments and taking different kinds of risks so that if one is hit by crisis, the others are not dragged down with it. A rich, diverse ecology of different economic systems is needed, not a banking monoculture of giant actors which leaves us vulnerable when they collapse.

2. *Launch a 'People's Bank' accessible through the Post Office branch network.*

The Government's award of the Post Office Card Account (POCA) gives no indication of increasing its very limited functionality, a missed opportunity for combating financial exclusion. Yet by increasing POCA's functionality, the Government could save the post office network and combat financial exclusion at the same time. POCA replaced the paper-based system of benefit and pension payment with an electronic card that can only be used at post offices to withdraw money deposited by the Government. There remains the opportunity to make post offices a central part of the Government's commitment to greater financial inclusion, by launching a post office bank along the lines of those in Italy and New Zealand, using the kind of Visa-embossed debit-card accounts that have been so successful in South Africa to tackle financial exclusion.

3. *Require banks to disclose their patterns of lending in disadvantaged areas.*

The basic assumption behind the 1977 Community Reinvestment Act in the USA is that banks must be prepared to lend money wherever they are prepared to accept deposits. The legal obligation to reveal where they are lending, and rating them accordingly, has raised loans to poorer people by 39 per cent (just between 1993 and 1998) according to a US Treasury study.³¹ The UK needs to legislate for compulsory disclosure by financial institutions of lending and investment in disadvantaged areas, as a means of tracking performance and stimulating the flow of finance to communities in need of redevelopment.

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