



**THE GREAT
TRANSITION**

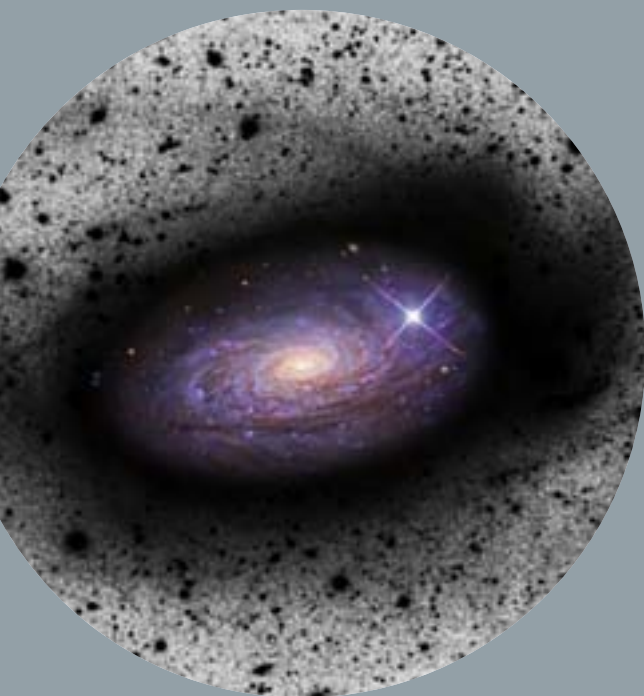
Necessary Desirable Possible



economics as if people
and the planet mattered

Where did our money go?

Building a banking system fit for purpose



nef is an independent think-and-do tank that inspires and demonstrates real economic well-being.

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.

Where did our money go?

Building a banking system fit for purpose

A report of the Great Transition

Contents

This report at a glance	1
Introduction	3
Summary	6
The roots of the crisis	6
Section 1. How did we get here?	11
A licence to print money?	11
A decade of easy credit – where did the money go?	13
What is a productive investment?	14
Re-appraising the role of banks in creating credit.	16
Section 2. Transparency – the missing information trail	18
Section 3. The banks and the rescue packages	25
Banks, credit and securitisation	25
The rescue packages	28
Section 4. Did it work?	35
Section 5. Into the present	48
A brief fiscal interlude	48
Banks in profit but the ‘funding cliff’ looms	49
The funding gap	51
Section 6. The Government and the banks	53
A question of influence	55

**Section 7. A new financial operating system
and a Green New Deal63**

Section 8. What should be done with banking?72

Out with the old.73

In with the new73

Better incentives for better behaviour74

Ensuring fairness, transparency and stability74

Endnotes76

Boxes

Box 1. What the banks are telling us20

Box 2. Capital ratios26

Box 3. £25 billion29

Box 4. The changing face of the British banking system30

Box 5. Lending commitments and actions36

Box 6. The lending dilemma – how to help small businesses42

Box 7. Where have all the branches gone?46

Box 8. Sir John Vickers and the Independent Commission.54

Box 9. From The Quiet Coup – Simon Johnson, former Chief Economist
at the International Monetary Fund55

Box 10. The Royal Bank of Scotland (RBS)65

Box 11. A manifesto for better banking68

Box 12. Move your Money: how the backlash against finance opens
opportunities for better banking71

Box 13: Public appetite for reform is ahead of government75

This report at a glance

This report reveals that:

- Public sector support for the banking sector amounts to at least **£1.2 trillion** committed, equivalent to 85 per cent of GDP – the highest level of any comparable economy.
- Given this enormous sum – in return there is a shocking **lack of information** in the public domain about where the money has gone, how it has been used, and what has been the ‘quid pro quo’ for the support.
- In spite of the scale of support, new lending to households and firms has **stagnated**.
- While the Bank of England has cut interest rates, interest rates for households and firms on many mortgages and other borrowing are **higher** than before the crisis.
- Overall **the banking system is borrowing more than it is lending**; its net lending to households and firms is negative.
- **Public stimulus has been the only effective medicine**. Any recovery has been driven by fiscal intervention supported by the central bank’s creation of money, otherwise known as ‘quantitative easing’. However, the nature of these programmes means that the recovery is likely to be limited and temporary, as many are now recognising.
- **The return of bank profits has come at a high and counter-productive cost**. Banks have returned to profitability, but their actions in doing so are detrimental to employees and customers: raising interest spreads between deposits and borrowing, cutting schemes favourable to borrowers, increasing fees, closing branches, and sacking employees.
- The banks’ **reliance on high-risk securitisation** processes has scarcely reduced; the Bank of England is critical of their strategies for reducing future reliance on these processes.

- Based on Bank of England data, banks now appear to face a **funding cliff**. In order to maintain existing levels of activity they currently have to borrow £12 billion a month; the projections we reproduce in this report indicate that in 2011 they will have to borrow **£25 billion a month**. We believe **the public sector is likely, once again, to be asked to bail out the banks for the emerging funding gap**.
- This amount now appears almost trivial against the scale of interventions to which the public has become accustomed. But it should be remembered that £25 billion is
 - one-half of annual current expenditure on **education**;
 - one-quarter of annual current expenditure on **health**;
 - more than the total value added of the electricity, gas and water supply industries; and
 - three times the value added of the agriculture, hunting, forestry and fishing industries.
- Further, there is a very real concern that **the breadth and depth of the current programme of public spending cuts is being influenced by the likelihood of another wave of bank bail-outs**. We believe fiscal consolidation processes are being driven at least in part by the consequent likely need for further public sector support to the financial system.

The economy continues to pay a very heavy price for the failures of the financial system. These matters affect every individual in the UK. At the end of the report we outline a **range of reforms** that we believe will be necessary to make the banking sector a useful servant of the productive economy and of the new economic, social, and environmental challenges we face. We also call for an open and inclusive public debate and inquiry on the reforms that should, at the very least, be required of the banks in return for current and future support.

Introduction

In putting in order the nation's finances, we must remember that this was a crisis that started in the banking sector. The failures of the banks imposed a huge cost on the rest of society.

Chancellor of the Exchequer, George Osborne
Presentation of the emergency budget, 22 June 2010

It is certainly a tragically comical situation that the financiers who have landed the British people in this gigantic muddle should decide who should bear the burden, the dictatorship of the capitalist with a vengeance.¹

Beatrice Webb (1858–1943)
English sociologist, economist and reformer

Chancellor of the Exchequer, George Osborne, unambiguously identified the roots of the UK's current economic crisis. Yet political action to redress the crisis, and ensure that a similar one does not recur, has been oddly one-sided and imbalanced.

The comedian Ben Elton once joked that nobody really understands economics, it just happens to you, like being mugged.

Today, the general public may justifiably feel like the victims of a mugging, but one in which they are subsequently required to pay for the daily living expenses of the person who attacked them, and who remains free and openly at large.

The previously unimaginable programme of cuts in public spending is the result of the banking crisis and the recession which followed. It is not the fault of the sectors and services now targeted. But, these are now massively out-of-pocket because of someone else's reckless, antisocial, and self-interested actions. In that sense it is like a mugging.

Yet, the Banks have been left virtually untouched. Little more is required of them in terms of transparency and accountability, and scant new regulation has been implemented to prevent a repeat of the crisis.

The former Chancellor, Alastair Darling, conceded in September this year that the so-called 'Super Tax' on bankers' bonuses had failed to change the behaviour of the industry in giving excessive, unjustified rewards to executives.

New rules have been introduced on how much capital a bank must hold compared to its liabilities. But, this agreement known as 'Basel III,' will only be phased in over the next decade. And many will no doubt be shocked to learn that current arrangements mean in effect that banks have only had to hold £2 in capital for every £100 lent (i.e., 2 per cent), and that new rules will raise that figure from £2 to £7 (or 7 per cent). Simon Johnson, former chief economist at the International Monetary Fund, suggests that this figure should be at least 15 per cent, and points out that the new threshold is actually lower than that held by many banks. As such, this too is unlikely to change the industry's behaviour.

Worse than this, some believe that the very scale of the cuts is partly being dictated by a government concerned to make provisions for yet another, future public bail-out of the banks in the event that they once again face collapse.

We are left with a banking sector of which it could be said on the flip of a coin, 'heads they win, tails we lose'. A private sector market which keeps its profits in the good times and makes the rest of us pay in the bad – privatised profits and nationalised costs and risks.

The imbalance in response seems to spread through current government policy.

For example, in seeking to restore public finances, the flea of benefit fraud is given huge political attention and may, extrapolating from Department for Work and Pensions data, lead to a share of savings of around £0.5 billion (which includes administrative error as well as fraud). Yet, at the same time the government has indicated a new 'soft' touch policy with regard to chasing taxes, whereby the tax avoidance industry is estimated to cost the public purse £25 billion, and tax evasion as much as £70 billion – around 190 times what might, generously, come from aggressively pursuing benefit fraud. It hardly needs adding that a tighter regime surrounding payment of benefits will disproportionately affect the poor, whilst a looser application of tax rules will disproportionately benefit the rich.

Such an approach is both economically inefficient in a time of recession – the poor are more likely to spend money productively back into circulation, stimulating the economy, than the rich whose additional wealth tends to add to asset price inflation. Also, the Institute for Fiscal Studies recently concluded that the overall impact of the Coalition government's 'emergency budget' was 'clearly regressive' and would hit the poorest households in the country worst.² Their 'take home cash' would fall 5 per cent by 2014, compared to just a 2 per cent fall for homes of average income.

This report seeks to address that imbalance.

The unprecedented scale of public cuts is only matched by the unprecedented scale of public support previously given to the banks.

More recently, estimates stemming from the banking sector's trade press suggest that the taxpayer might make a small profit on its stakes in the banks.³ A widely reported and rounded-up figure of £30 billion by 2015 was circulated. This, however, quickly broke down into a number of 'hoped for' outcomes. It depended on confident predictions of economic growth being realised and did not account for the possibility of a second recessionary dip and a critical, growing funding gap.

Also missing from the figure was the large cost to the economy of the recession itself in terms of reduced activity and rising unemployment. The financial crisis is estimated to have cost the UK £129 billion in annual GDP. And, looking to the future, the value of subsequent cuts in public services also carries multiple social and economic costs. More importantly, as we project later, the banks are, in fact, facing a huge, continuing funding shortfall, the bill for which is highly likely to fall once again on the British taxpayer.

This report asks where did our money go, who has benefited, and what was asked of them in return? Beyond that we interrogate what has happened since. Is the cuts agenda right? What will be its consequences? What are the alternatives? Finally we ask, what should be done to prevent future crises, and how should banking change in order to be useful to the wider, productive economy and society?

There are two over-riding conclusions.

First is that, considering the generational impact of the banking failure, and the scale of subsequent public support given to the banks, action to correct past systemic problems in the finance sector and to prevent future crises, has been woefully inadequate.

Secondly, in a linked but separate way, considering the major new economic, social, and environmental challenges we face, the banking system we now have is not fit for purpose. To tackle recession, the urgent shift to a low carbon economy and worsening levels of corrosive social inequality will need what **nef** (the new economics foundation) calls a 'Great Transition'. Such change we believe is necessary, possible, and desirable. But, it is clear from this report, that we have a finance system which is not fit for purpose. At the end of the report we outline what kind of system would be.

Summary

The management of market risk and credit risk has become increasingly sophisticated. . . Banking organizations of all sizes have made substantial strides over the past two decades in their ability to measure and manage risks.

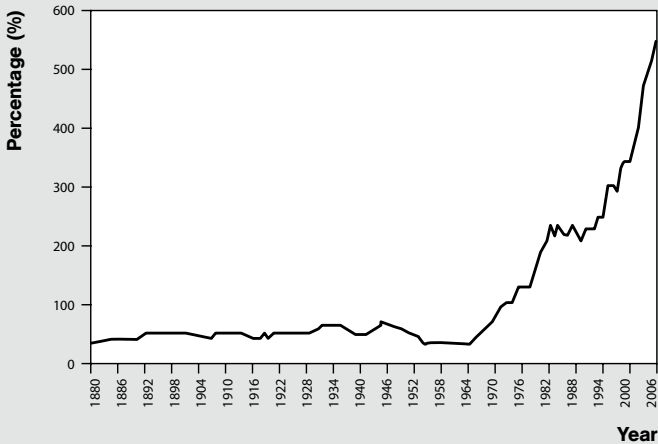
Ben Bernanke, 12 June 2006⁴

Ben Bernanke is the Chairman of the US Federal Reserve, the organisation which surely bears the most responsibility for the conduct of the global financial system. His preparation for this role was as an economist, and specifically a scholar of the Great Depression. Given these qualifications, the absurdity of this misjudgement of banks' ability to manage risks cannot be exaggerated. Just over a year after he made this statement, the global financial system froze, marking the start of the financial and economic crisis currently known more in hope than in reality as the Great Recession. It was in 2007 that the European Central Bank began the public support for the financial sector that grew quickly to colossal scale.

The roots of the crisis

It is hard even to credit that he could have been so wrong. The economic history of the world indicates that crisis after crisis arises from financial failures. These failures follow from one simple cause: the over-extension of credit. Banks lend in quantities and at rates of interest that go beyond the ability of borrowers to repay. Banks lend to each other and drive up the value of assets. Banks hide activity off balance sheet. These practices have existed whenever banking systems have developed. In Britain in the 1700s, there was the South Sea Bubble; in the Netherlands in the 1600s, there was Tulipomania. In his book on the Great Depression, John Kenneth Galbraith reserved a whole chapter for a bank that many regard now as the most powerful in the world: he called it "In Goldman Sachs we Trust".⁵ With banking unrestrained, economies become based on speculation, and productive activity and work take second place; the rich profit and the poor suffer.

More likely is that Bernanke – as with politicians in all OECD economies – was simply unable to admit the dangers that were so obvious to so many outside the economics

Figure 1. UK Banking sector assets as % of GDP

Source: Haldane AG, Alessandri P (2009) 'Banking on the State', Bank of England, November 2009.

profession. To do so would be to concede the failure of the whole system; a system which they and their predecessors had implemented, supported, and extended; a system in the development of which they had been deeply involved. Since the late 1960s, the world economy has danced more and more frenziedly to a tune played by the financial sector. Haldane's⁶ chart makes the turning point somewhat obvious (Figure 1).

The USA, and through it the world, was indoctrinated into thinking that what was good for Wall Street was good for the country. In Britain, New Labour became the most fervent of the financial sector's admirers. In his 22 June 2006 Mansion House Speech, given less than two weeks after Bernanke's remarks, Gordon Brown celebrated his resistance to those who wanted to regulate finance:

In 2003... the Worldcom accounting scandal broke. And I will be honest with you, many who advised me including not a few newspapers, favoured a regulatory crackdown.

I believe that we were right not to go down that road which in the United States led to Sarbanes-Oxley, and we were right to build upon our light touch system through the leadership of Sir Callum McCarthy - fair, proportionate, predictable and increasingly risk based. I know Sir

Callum is committed to reducing regulatory administrative burdens and the National Audit Office will now look at the efficiency and value for money of our system.

The extent of the failure is revealed by the extent of the crisis. Yet there has been no diminution of the power of the financial sector; in fact, the crisis is serving mainly to reveal the extent of that power. At each step of the way since crisis began, the bankers have called the shots. Even the Governor of the Bank of England, Mervyn King, has remarked:

The sheer scale of support to the banking sector is breathtaking. In the UK, in the form of direct or guaranteed loans and equity investment, it is not far short of a trillion (that is, one thousand billion) pounds, close to two-thirds of the annual output of the entire economy. To paraphrase a great wartime leader, never in the field of financial endeavour has so much money been owed by so few to so many. And, one might add, so far with little real reform.⁷

Moreover, from the point of view of society as a whole, the strategy has failed. Any modest increases in output have not been sustained, private activity has not been restored, and the great rise in unemployment has not been reversed. And now, in the depths of this mess, society faces an unprecedentedly severe assault on public sector services and jobs. Moreover, as Mervyn King indicates, there has still been no serious challenge to the manner in which society organises its financial affairs.

This publication is aimed at detailing these affairs. On one level, the matters appear complex, but public discussion has tended to overcomplicate and not to clarify. No doubt an open public debate would not be in the interests of the financial sector, which gains to such a staggering extent from a system that has become opposed to the interests of the wider public. But the public is beginning to learn that it has been deceived. **nef** finds:

- Public sector support for the banking sector amounts to at least **£1.2 trillion** committed, equivalent to 85 per cent of GDP – the highest level of any comparable economy.
- Given this enormous sum – in return there is a shocking **lack of information** in the public domain about where the money has gone, how it has been used and what has been the ‘quid pro quo’ for the support.

- In spite of the scale of support, new lending to households and firms has **stagnated**.
- While the Bank of England has cut interest rates, interest rates for households and firms on many mortgages and other borrowing are **higher** than before the crisis.
- Overall **the banking system is borrowing more than it is lending**; its net lending to households and firms is negative.
- **Public stimulus has been the only effective medicine.** Any recovery has been driven by fiscal intervention supported by the central bank's creation of money, otherwise known as 'quantitative easing'. However, the nature of these programmes means that the recovery is likely to be limited and temporary, as many are now recognising.
- **The return of bank profits has come at a high and counter-productive cost.** Banks have returned to profitability, but their actions in doing so are detrimental to employees and customers: raising interest spreads between deposits and borrowing, cutting schemes favourable to borrowers, increasing fees, closing branches, and sacking employees.
- The banks' **reliance on high-risk securitisation** processes has scarcely reduced; the Bank of England is critical of their strategies for reducing future reliance on these processes.
- Finally, based on Bank of England data the banks now appear to face a **funding cliff**. In order to maintain existing levels of activity they currently have to borrow £12 billion a month; the projections we reproduce in this report indicate that in 2011 they will have to borrow **£25 billion a month**. We believe **the public sector is likely, once again, to be asked to bail out the banks for the emerging funding gap**.
- This amount now appears almost trivial against the scale of interventions to which the public has become accustomed. But it should be remembered that £25 billion is:
 - one-half of annual current expenditure on **education**;
 - one-quarter of annual current expenditure on **health**;

- more than the total value added of the electricity, gas and water supply industries; and
 - three times the value added of the agriculture, hunting, forestry and fishing industries.
- Further, there is a very real concern that **the breadth and depth of the current programme of public spending cuts is being influenced by the likelihood of another wave of bank bail-outs**. We believe fiscal consolidation processes are being driven at least in part by the consequent likely need for further public sector support to the financial system.

The economy continues to pay a very heavy price for the failures of the financial system. These matters affect every individual in the UK. At the end of the report we outline a **range of reforms** that we believe will be necessary to make the banking sector a useful servant of the productive economy and of the new economic, social, and environmental challenges we face. We also call for an open and inclusive public debate and inquiry on the reforms that should, at the very least, be required of the banks in return for current and future support.

Section 1.

How did we get here?

A licence to print money?

Banks perform two vital functions in relation to the nation's supply of credit: they decide how much there should be, and they decide who should get it. Most people would recognise the second function but assume that banks can only lend money which someone else has already deposited with them as savings or in a current account. In fact, the process works in exactly the opposite way. The bank makes a loan and creates a new deposit to match it.

By way of a highly simplified illustration, if a bank makes a loan of $\pounds 1,000$, it adds an asset of $\pounds 1,000$ to its balance sheet representing the amount it will be repaid by the customer. It also credits the customer's current account with the same amount effectively creating $\pounds 1,000$ of new electronic money.^{8,9}

To the extent they have thought about it at all, most people would have assumed that the Bank of England decided how much money in total was injected into the economy. Indeed the creation of what we traditionally think of as money, namely cash, is tightly controlled by the Bank of England Act of 1844 and only the state can print paper money and mint coins. With the advent first of cheques and now of electronic banking, this central bank issued money has become less important over time, and commercial bank created money has become dominant. Increasingly, transactions take place electronically with fewer than 59 per cent of transactions using cash,¹⁰ a fourfold increase in the value of debit card transactions in the last decade reaching $\pounds 264$ billion in 2009, almost the same as the value of cash transactions of $\pounds 267$ billion the previous year.¹¹ At the end of 2009, the total stock of notes and coins stood at a mere 2.5 per cent of the total amount of UK bank deposits.¹² The system of money creation is largely privatised.

This phenomenon seems startling at first sight, but is long observed and well documented, for example:

... the fractional reserve system... permits the banking system to create money.

Federal Reserve Bank of Kansas City

The actual process of money creation takes place primarily in banks.

Federal Reserve Bank of Chicago¹³

The process by which banks create money is so simple that the mind is repelled.

John Kenneth Galbraith¹⁴

The crucial point about the development of banking that is usually overlooked is that it permits the authorities control of the rate of interest. Through history the emergence of banking has been accompanied by great reductions in the rate of interest; reductions that, in turn, permit economic activity to flourish and societies to prosper.¹⁵ Therefore, it is important to emphasise that the system of fractional reserve banking has been a significant driver of economic development, but to be successful it requires at least three conditions to hold true:

- 1.** Banks select economically useful enterprises, and financially sound individuals, to lend to, and do not create excessive credit for speculation and activities that do not add to GDP.
- 2.** There is no sudden loss of confidence that leads to customers trying to withdraw all their money at once, which is of course impossible as only a fraction of their deposits actually exist in the form of cash.
- 3.** The system operates so that control over the rate of interest is maintained

Government and regulators have a large part to play in preventing the loss of confidence that results in a run on the banks and ultimately this requires banks being provided with a highly valuable deposit guarantee scheme funded at taxpayers' expense. As we saw with Northern Rock, if this guarantee is called upon it can be expensive indeed for the taxpayer. The fairness of a scheme that sees taxpayers with little or no financial assets compensating individuals wealthy enough to hold up to £50,000 on deposit at a bank is an interesting question in itself, but not considered here.

Have they delivered on the first condition – productive and sound lending?

A decade of easy credit – where did the money go?

You are a den of vipers and thieves. I intend to rout you out, and by the eternal God, I will rout you out.

Andrew Jackson (1767–1845) 7th US President, to a delegation of bankers discussing the Bank Renewal Bill, 1832

The first decade of the new millennium was an exciting time to be a banker. In retrospect it was appropriately called the ‘noughties’. Prior to the crash in 2008 the financial services industry seemed invincible, innovative, and highly profitable. Banks took advantage of so called ‘light-touch regulation’ to rapidly inflate their balance sheets and in the UK they were hailed as a national success story – an engine of growth for the economy. Never ones to be shy of high remuneration, stories of multi-million pound bonuses and the £35,000 cocktail abounded.¹⁶ But any squeamishness about such financial excesses, the power of the investment banks, the size and complexity of the giant banking conglomerates, and the exotic new financial instruments being traded by high street banks was brushed aside. The bankers knew what they were doing and thought they were worth every penny. Of course the party had to end, and the bell was rung for last orders by the mounting non-payment of sub-prime mortgages in the USA.

These loans, often badly assessed at best and at worst mis-sold, had been sliced up, repackaged and resold to financial institutions around the world as Collateralised Debt Obligations (CDOs). These were frankenstocks of sufficient complexity to baffle all but the most dedicated number cruncher and conveniently well beyond the understanding of most senior executives and shareholders, although Warren Buffett had identified derivatives in general as “financial weapons of mass destruction” earlier in the decade.¹⁷ Once it became clear that the underlying loans were unlikely to get repaid, a tidal wave of concern swept through the financial system, leaving banks too fearful to lend to one another. Northern Rock was the first UK casualty, running aground in September 2007 and finally being rescued by the public lifeboats in February 2008. House prices around the world began to slide as they could no longer be propped up with easy credit. The economic contraction caused by the credit crunch outlook was further worsened by severe spikes in food and fuel commodity prices in 2007 and 2008. Bear Stearns collapsed in March 2008, but the crisis reached its zenith with the fall of Lehman Brothers in September. The global financial system stood on the precipice and could only be pulled back by a combination of rock-bottom interest rates, takeovers of failed banks, and the unprecedented and truly staggering sums of financial support pledged by governments around the world – as detailed in this report.

What is a productive investment?

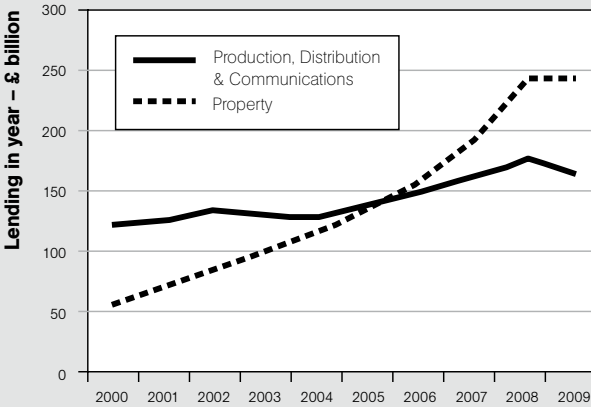
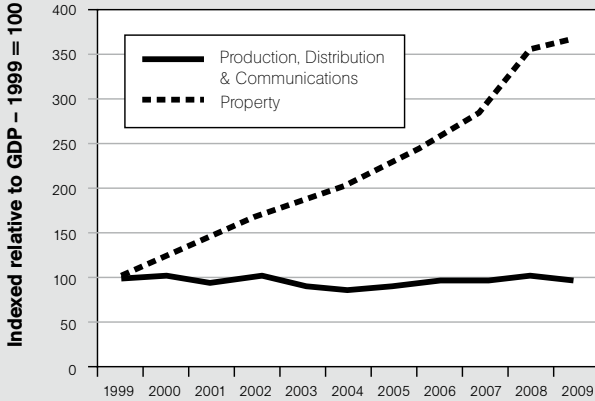
What counts as a productive investment is perhaps in the eye of the beholder, or rather the borrower, but there is no better illustration of how commercial banks can collectively chase returns in unproductive activities than the story of commercial property.

The past decade saw a stark increase in lending to the commercial property sector. This includes the development, buying, selling, and renting of property but excludes the actual construction of new buildings. Lending to this sector grew by over 3.5 times the rate of increase in GDP over the period. To put this into context, lending to all other non-financial business sectors lagged slightly behind growth in GDP. Lending to these sectors, which include the construction industry as well as communications, retail, and manufacturing, flatlined in relative terms. Commercial property lending switched from being 60 per cent less than lending to productive sectors to being 50 per cent more.

Undoubtedly the provision and management of retail, office, and industrial property is an important function within the economy, but it stretches credulity to imagine that trading in assets can ever be an engine of economic growth as it does not add much to the productive capacity of the economy. This was one of the asset bubbles that developed during a long credit binge, with the now state-owned Lloyds and Royal Bank of Scotland parting particularly hard. The collapse in commercial property value since the financial crisis developed – a 26.4 per cent decrease in 2008 alone¹⁸ – has left these banks, and therefore the taxpayer, with a nasty headache. More than £55 billion of UK commercial property debt, of a total of around £240 billion, is due for renewal in 2010 but loans are going bad at an alarming rate with another £50 billion of loans in breach of terms. Around half of these dodgy debts are owed to the two state-owned failed banks.¹⁹

Other examples of where RBS chose to invest its funds include US sub-prime mortgage backed securities leading to losses of around £7 billion in 2008, a £2.5 billion loan to Russian billionaire Leonid Blavatnik which had to be written off entirely when his chemicals business collapsed,²⁰ while in January 2010 the now state-owned bank earned the condemnation of opposition politicians when it helped fund the £11.5 billion hostile takeover by Kraft of Cadbury's – a deal expected to lead to significant job losses and closure of productive capacity in the UK.²¹

Figure 2. Why lend to boring businesses when playing monopoly is so much more exciting?



Source: nef calculations from Bank of England Industrial Analysis of Lending (Table C1.2). 'Production, Distribution and Communications' is the sum of retail, manufacturing, agricultural & communications and includes construction. 'Property' is the development, buying, selling and renting of real estate and excludes mortgage lending. GDP is gross domestic product at market prices taken from Bank of England data series YBHA.

Re-appraising the role of banks in creating credit

We argue that an effective banking system should channel resources into financially sound investment that creates social value without causing environmental degradation.²² The investment required over the next ten years in green infrastructure has been estimated at £550 billion.²³ Can a largely unchanged banking industry deliver on this investment requirement, and given its track record over the past decade can we entrust the credit allocation to vital industrial sectors of the future entirely to commercial banks? Have they earned their privilege of credit creation and allocation?

There is a reason why commercial banks enjoy this enormously profitable privilege. The belief has been that were the government to create all the money in the economy, it would lead to three negative consequences:

1. it would do a very bad job of choosing economically useful projects to spend the money on;
2. it would be unable to resist the temptation to create too much money, leading to inflation or even hyper-inflation; and
3. the end result would be a financial crisis.

Instead it has been an article of faith that governments must not create money, that the independent central bank should try to control inflation only through the indirect tools of interest rates and money market operations, and that clever and professional private bankers should use their skills to assess the quality of each application for credit and ensure that it is an economically viable loan.

Unfortunately the events of 2008 have revealed that the privatised system of money creation has led to three negative consequences as outlined in this report:

1. the banks did a poor job of choosing economically useful projects to lend the money to;
2. they were unable to resist the temptation to create too much money, leading to asset price inflation (particularly in property); and
3. the end result was a financial crisis.

It is possible to draw two conclusions from this analysis. First, a return to business as usual is likely to merely be the seeds of the next banking crisis. Fundamental institutional reform is required to ensure that the central bank has more ability to dampen excessive credit creation for unproductive activities, and to address the market failures that result in chronic underinvestment in low-carbon infrastructure and productive capacity. Second, and possibly more fundamentally than this, it is time to review the current monetary system that puts the power of credit creation almost entirely in the hands of commercial banks – banks that have not only failed to look after the interests of society and the environment, but cannot even manage to look after the interests of their own shareholders.

Section 2.

Transparency – the missing information trail

There is an impression that a typical householder wanting to cut down a tree or build a modest home extension would have to provide more information to a local council than the nation's biggest banks had to provide to the public in return for their biggest bail out in history.

Alongside the apparent complexities of the mechanics of the financial system are great difficulties arising from the unavailability of data on important phenomena and a more general lack of transparency in the debate following the crises of the last three years.

Ever since the Government granted the Bank of England independence over interest rate setting, the policy-maker mantra has been of the virtues of transparency. The publication of Monetary Policy Committee deliberations would ensure that market participants better understand the reasoning for policy decisions; moreover there was a virtuous circle, transparency led to the more effective transmission of policy.

Equally, openness and relevance are central themes of the principles governing the production of the official statistics that support economic policy decisions. The UK Statistics Authority Code of Practice begins:

Principle 1: Meeting user needs

*The production, management and dissemination of official statistics should meet the requirements of informed decision-making by government, public services, business, researchers and the public.*²⁴

For those members of the public interested in the financial sector, there are a number of major shortcomings in the publically available record:

- details of the scale of taxpayer intervention under the rescue packages are not readily available;

- details of gross bank lending to businesses are not available;
- information on the cost of borrowing to business is not available; and
- individual banks do not publish estimates of their reliance on securitisation processes or on government support.

This lack of availability is all the more worrying given some of the figures are critical to the debate and associated controversy.

There is also some evidence that these difficulties have been exacerbated under the Coalition government. The June 2010 *Budget* document included no discussion of the rescue packages, in contrast with the March document. The Bank of England's August *Financial Stability Review* also gave no such update, despite a good deal of information in the previous edition.

In recognition of the transparency issue, in July 2009 the Office of National Statistics (ONS) published a special edition of the *Economic and Labour Market Review*. They approached the issue through the perspective of the public sector accounts, and drew attention to the International Monetary Fund's (IMF) Code of Good Practices on Fiscal Transparency:²⁵

The public should be provided with comprehensive information on past, current, and projected fiscal activity and on major fiscal risks... ONS has a key role to play, however, in presenting the data necessary for assessment of fiscal burden and risk, and as such needs to understand user requirements beyond the National Accounts boundary. The liabilities in this category which will attract the most attention are; future expenditure under PFI, unfunded pension schemes and government guarantees.

While estimates of these liabilities are disclosed as memorandum items or notes in departmental resource accounts, they are not systematically presented in aggregate (whole of government) form.

From the perspective of financial sector intervention, interest must go wider than the fiscal risk alone. Nonetheless we support the ONS aim to: "... consider its role in presenting a wider range of data on government and public sector liabilities, as is the case in other countries",²⁶ and the other more detailed recommendations made in the report.

Box 1. What the banks are telling us

In December 2008, the American news agency Associated Press (AP) contacted banks in the United States that had received at least \$1 billion in government support. They asked four questions:

1. How much has been spent?
2. What was it spent on?
3. How much is being held in savings?
4. What's the plan for the rest?

“It’s something any bank would demand to know before handing out a loan,” wrote AP, “Where’s the money going?” But their questions were met either with vagueness, or a straight refusal to discuss them. “We have not disclosed that to the public” said JPMorgan Chase, for example, which received a \$25 billion bailout. “We’re declining to.”²⁷

For this report, we repeated the exercise on a smaller scale for Britain’s banks. They are quick to stress that the government’s billions were crucial in supporting the industry in the dark days of October 2008 and in shoring up confidence in the financial system.

But the banks cannot, or will not, pinpoint what they have spent the money on or how it has been re-circulated back into the economy. RBS and Lloyds who received direct government injections of aid insist they have not spent a penny of it. Those funds are supporting their balance sheets with an additional layer of so-called tier one capital. This is the most solid form of funding and is there to be called on in a crisis.

The fact that taxpayers’ money is still sitting on banks’ balance sheets goes some way to explain the howls from small businesses about the difficulties of obtaining loans. Banks have become ultra-cautious and to some extent are hoarding capital.

“That money isn’t and wasn’t spent,” says a spokesman for RBS which received a bail-out of £20 billion in October 2008. “It is there to support RBS

in a worst-case scenario.” Banks have been carrying out stress tests with the regulator to model how much funding they would require in an economic meltdown. Since the financial crisis, The Financial Services Authority, the chief City regulator, requires banks to carry greater buffers of capital. But some suggest RBS may now have too much capital.

Under the reign of former Chief Executive, Sir Fred Goodwin, RBS was run with very thin capital ratios as a deliberate strategy partly to provide the funding for Sir Fred’s ambitious expansion plans. But in 2007, RBS over-stretched itself with the disastrous acquisition of Dutch bank ABN Amro which led a year later to the need for the bail-out.

RBS is also the one bank still to benefit from the government’s asset protection scheme to insure toxic assets clogging up banks’ balance sheets – Lloyds left the scheme last year.

RBS has an insurance policy from the government worth £60 billion to insure some £200 billion of toxic loans and mortgages. It pays a fee of £500 million a year to the government for this insurance and is committed to paying an eventual £2.5 billion even if it leaves the scheme before the end of five years.

The bank says the government’s funds have given it breathing space to change its business, reduce its reliance on wholesale funding, and get rid of some of its toxic assets. However, the bank is still concerned about economic uncertainty and although it made a profit of £1.1 billion in the first half of the year, it remains cautious.

Lloyds is more reluctant to talk about its own bail-out aside from pointing out that it received £19.9 billion from the government and has paid back fees of £2.5 billion. Lloyds needed the capital injection chiefly to prop up HBOS which it took over in an emergency merger in the middle of the financial crisis. The bank didn’t want to tell us its capital position, instead it sent a factsheet on what it is doing to lend to and support small businesses.

Banks have not just benefited from direct government aid. The Bank of England’s asset purchases under its quantitative easing programme and emergency funding facility under the special liquidity scheme, have all

helped to bolster banks' balance sheets although none can quantify the benefits of these schemes.

John Varley, Chief Executive of Barclays, that raised money from private investors rather than depend on a government injection said last year : “Even those banks who did not take capital from governments clearly benefited (and continue to benefit) from these actions. We are grateful for them, and our behaviour should acknowledge that benefit.”²⁸

Barclays, in particular, was able to take advantage of a stronger banking system. It bought core assets from the US arm of investment bank, Lehman Brothers, for just £1 billion in the days following its collapse. That business has since proved extremely profitable and the shell that remains of Lehman is suing Barclays for a £3 billion profit it says the British bank made on the deal.

Barclays raised £7 billion in additional capital after the financial crisis by seeking funds largely from the royal families of Abu Dhabi and Qatar – as well as a small amount from existing shareholders – rather than the UK government. HSBC also asked its own investors for funds in the biggest cash call in UK corporate history when it raised £12.5 billion last year.

On the foundations of public support, the banks have returned to profit. Most are paying out large bonuses to employees in a repeat of the corporate incentive system which led to the behaviour behind the original crisis.

This is what the banks were prepared to tell us:

How much have you benefited from government support to the banking sector?

RBS: “—”

Lloyds: “—”

Barclays: “Barclays has made clear its gratitude for how much governments did to rescue the system when it needed it. But it is important to distinguish between institution specific support and systemic support. Barclays has benefited from the latter but not the former.”

HSBC: Raised £12.5 billion from its own investors and did not need government support. Michael Geoghegan, Chief Executive, said in November 2008: “I hope these guarantees are not in place for too long. They may create the wrong type of behaviour by managements in those banks.”²⁹

How much has been spent?

RBS: “The bank bail-out money isn’t and wasn’t spent.”

Lloyds: “The UKFI annual report notes a total investment in LBG (before taking into account any fees repaid) of £19,933 million. Taking into account fees repaid, this figure stands at £17,433 million.”³⁰

What was it spent on?

RBS: “The bank bail-out money isn’t and wasn’t spent.”

Lloyds: Sent us a flyer about the bank’s commitment to lending to small businesses.

How much has been used to support your balance sheet?

RBS: “The money is there to support RBS’ capital in a worst case scenario. We are carrying out stress testing with the FSA over how much money we have in our coffers to withstand a worst case scenario. The money is there to provide that stability so that people have confidence their deposits are safe.”

Lloyds: The money remains on the balance sheet.

What has happened to the rest?

RBS: “Uniquely, RBS has an insurance policy – if losses get to a certain level, we are insured for those losses (through the government’s asset protection scheme). The insurance is worth £60bn and RBS pays a fee of £500m a year for it – up to a level of £2.5bn.”

Lloyds: Decided to leave the asset protection scheme last November. At the time it paid £2.5 billion to exit.

Section 3.

The banks and the rescue packages

A banker is a fellow who lends his umbrella when the sun is shining and wants it back the minute it begins to rain.

Mark Twain (1835–1910)
American author and humourist

Banks, credit, and securitisation

The fallacy that banks are middlemen between depositors and borrowers is commonly repeated, especially by those in the financial sector. As **nef** has argued on many occasions, banks instigate lending; they are not constrained by deposits. While today the manner of these processes appears to be scarcely understood by mainstream economists and even policy-makers, in 1954 the great economic historian Joseph Schumpeter was able to observe:

Nevertheless, it proved extraordinarily difficult for economists to recognize that bank loans and bank investments do create deposits ... And even in 1930, when the large majority had been converted and accepted that doctrine as a matter of course, Keynes rightly felt it necessary to re-expound and to defend the doctrine at some length.³¹

Joseph Schumpeter (1883–1950) Austrian economist

As many have understood, this ability to *create* lending (i.e. to create *credit*) has both enormous benefits and enormous dangers. The dangers arise from a conflict of interest between the owners of the banking system and the economy as a whole. Nothing is closer to alchemy than the creation of credit. With very little effort and cost, banks can create a huge amount of lending which generates interest income and profit. There will always be a temptation to over-lend: to lend beyond borrowers' ability to repay from future earnings or the banks' liquidity and capital resources. It is a powerful temptation: the major crises of economic history have at root cause over-lending.

Box 2. Capital ratios

Under the Basel Accords, banks have been required to hold certain capital assets against loans (weighted according to risk). The calculation of ratios is illustrated from the greatly simplified asset side of the balance sheet statement below:

Assets, £ billion

Cash and balances at BoE	20
Loans and advances to customers	500
Available for sale financial assets	50
Total	570

Capital ratio = financial assets / loans = 50 / 500 = 10%

International regulators then set acceptable levels or ranges for these ratios. As present events indicate these processes are convoluted, slow and of questionable value. Under the Basel III accord the 'core capital' ratio was recently raised from 2 per cent to 7 per cent, although the actual figure is allowed to vary depending on financial conditions.

The regulation of the financial sector is testament to these considerations, and regulation sought to prevent over-lending. Normally the approach has been to require banks to hold certain assets (deposits at the Bank of England, and equities or bonds) in specified ratios to the total amount of lending (which is also an asset to banks) (Box 2). Banks of course have a major incentive to operate around any regulation and liquidity requirements.

In the context of the present crisis, the monetary theorist Victoria Chick³² described the nature of securitisation processes:

[After the banks had run down their liquid assets] *there was really only one source of liquidity left: the banks' 'illiquid' assets, their loans. Following a technique developed in the USA in the 1970s, UK banks began to securitise their assets. In... 1990 I characterised this as the 'sixth stage of banking' (Chick 1993).*³³ *Banks repackage assets and sell securities for which the packages are collateral through a 'special*

purpose vehicle' (SPV). Securitisation gets the illiquid assets off the bank's balance sheet – or at least it appears to do – and restores liquidity, but it shifts the burden of liquidity provision from the market for short-period, very safe securities like Treasury bills to a more lucrative but uncertain market. (The fact that the supply of Treasury bills and gilts was also drying up one might argue forced the banks' hand.)

She also argues that the international regulatory accord, Basel I, did the real damage in the UK.

The removal of risky assets from the balance sheet became even more important after the first Basel Agreement (1988), establishing capital adequacy controls by means of required capital, itself differentiated into two 'tiers' as ratios to risk-weighted assets. (It cannot be an accident that the first rules attempting to regulate capital adequacy were agreed just as the liquidity cushion had lost almost all its stuffing. Once there is no liquidity provision, solvency is the next thing to worry about, though paradoxically the framers of Basel appear to have thought that the liquidity question had been solved and was not a cause for concern.) The Basel Agreement and its successor, Basel II, illustrate the law of unintended consequences: regulations which were intended to strengthen the balance sheets of banks by weighting assets by risk, thus rewarding the holding of safe assets, actually drove risky assets off the balance sheet. As a result of Basel, securitisation was undertaken not just a small part of bank operations when banks needed liquidity, but on such a scale as to change the whole way banks operate.

Banks earned fees from securitisation, and lending standards deteriorated:

The old model in which banks held assets to maturity has been superseded by the 'initiate and distribute' model. Banking can no longer be modelled in terms of a simple balance sheet, for a great deal of activity now takes place off the balance sheet. The proportion of income earned from the interest spread has declined as that from fees and commissions has become more important. Selling on loans may be a source of liquidity provision and convenient for the avoidance of Basel regulations, but it also means that (a) banks no longer have an on-going interest in, or the capacity to monitor, the loans they make and (b) with re-packaging, it is very difficult to evaluate the risk of

claims on these loans. The ratings agencies claim to do this, but it is generally agreed that they underestimated risk. It may also be the case that their ratings were misinterpreted as having a wider application than purely the risk of default.

The processes are such that it is highly complex to even ascertain where associated securities ended up. Presumably some related risk has gone to pension funds; though it is possible that some assets simply go round and round the banking system. These matters demand more investigation.

Sub-prime lending in the US is normally regarded as the cause of the crisis. But really it exemplifies the depths to which bad lending practice had sunk. Banks lent to everybody they could, irrespective of the probability of repayment. To lend money to people with no income and no job to buy a home is the end point of a structure of lending to households and firms that is in total disarray. Between good lending and sub-prime there is likely to be a lot of bad lending.

The financial and economic crisis began when the market for securitisation and 'funding' through inter-bank markets collapsed. At that point there was nobody to buy the assets comprised of banks' lending, wider asset values collapsed and regulatory ratios [failed] were reduced below acceptable or required levels. Banks were forced to confront an effective insolvency.

The 'somebody else' to whom Victoria Chick referred has turned out to be the taxpayer.

The rescue packages

The financial collapse actually began in the Eurozone, with the European Central Bank (ECB) the first to intervene in the inter-bank market. It arrived most forcefully in the UK with Northern Rock. The building-society-turned-bank had developed a system which relied on securitisation and funding through markets to an extreme extent. In September 2007, it asked the Bank of England for an emergency borrowing facility. Following a good deal of dithering, the Bank of England began to inject money to a total of £25 billion.³⁴

Over the next years there were other specific institutional failures (e.g. Bradford and Bingley, London Scottish, transactions with banks in Iceland) but soon far more extensive packages aimed at the whole banking system were implemented.

Box 3. £25 billion

This amount now appears almost trivial against the scale of interventions to which the public has become accustomed. But it should be remembered that £25 billion is:

- one-half of annual current expenditure on education;
- one-quarter of annual current expenditure on health;
- more than the total value added of the electricity, gas, and water supply industries; and
- three times the value added of the agriculture, hunting, forestry and fishing industries.

The first major package was announced in October 2008 by HM Treasury, and introduced the public to a number of schemes such as the special liquidity scheme (though this had been operating since April) and the credit guarantee scheme and recapitalisations. Reflecting an ongoing inadequacy of the arrangements, other packages involving major extensions to existing schemes and new schemes were announced in January and November 2009.

It is difficult to capture exactly what each of the schemes is about without going into a great amount of technical detail. The IMF's later endorsement was of a 'three pronged approach': liquidity provision, capital injections, and dealing with problem assets. The Bank of England has adopted an alternative schematisation so that schemes are divided into central bank schemes, based on money creation or swaps, and government schemes based on insurance, guarantees and recapitalisation.

In very general terms, the authorities either:

- provided money to meet day-to-day expenses (liquidity provision);
- invested in (or injected capital into) organisations (buying equity);
- insured lending (so that banks pay a premium for the government to protect certain liabilities); or
- removed 'impaired' (i.e. bad) assets from banks.

Box 4. The changing face of the British banking system

Over the past 20 years, liberalisation measures have seen building societies mutating into banks, failures of banks and building societies, and banks taking each other over; the face of banking is now very different. The Bank of England now defines the ‘major British lenders’ as follows:³⁵

- Banco Santander – who took over Abbey National
- Barclays – now a retail-investment bank following merger with BARCAP, its investment arm
- HSBC – Hong Kong and Shanghai Banking Corporation, who took over Midland
- The Lloyds Banking Group – formed after the merger of Lloyds TSB and HBOS.
- Nationwide – still a building society
- Royal Bank of Scotland – took over NatWest (now in the public sector)

These operations are generally time-limited (on different horizons) and operate according to various terms and fees with the banks. Schemes have been concocted according to an idea that if they are successful the government will end up with a profit.

The Bank of England’s perspective is probably the most useful for analytical purposes (see Table 1 for a summary statement).

Central bank schemes

Under *swap* schemes, the central bank takes certain ‘eligible’ assets off the banks’ hands in exchange for government instruments that can be easily exchanged for cash; these exchanges are reversed at pre-arranged dates. The two main schemes are:

- the *special liquidity scheme (SLS)*, operational first in April 2008, under which banks could initially swap (i.e. offload) “high-quality, but temporarily illiquid, mortgage-backed and other securities for UK Treasury bills.”³⁶ The idea being

that the bills could then be used as an additional source of liquidity. The scheme was large-scale (reaching £185 billion) and would offer liquidity for three years. While the scheme is open until 2012, the window for new issues is now closed.

- The *discount window facility (DWF)* was presented as a *permanent* successor to the SLS (though it was introduced before the SLS closed). The scheme permits the exchange of a wider range of collateral; originally the swaps were for 30 days, but this was extended to one year.

Unfortunately there is no information on the scale of activity under the DWF, in spite of its apparent importance to the strategy. The Bank of England publication *Bankstats* includes Table 1.

Table 1 is not entirely uninformative: note the difference between quarters registering ‘-’ and those registering a blank. A dash indicates no usage; the spaces indicate unspecified usage. The ONS also records that there was a transfer of £50 billion to the scheme from the National Loans Fund.³⁷

The main *money creation* scheme on the part of the central bank is more commonly known as ‘quantitative easing’:

Table 1. Bank of England discount window facility lending (£ millions)

Average daily values in £ millions		
	Usage - 30 Day	Usage - 364 Day
2009 Q1	-	-
Q2	-	-
Q3	-	-
Q4	-	-
2010 Q1	-	-

Note: 30 day usage figures taken from Bank of England data series YWQB07T ‘Bank of England Discount Window Facility, average daily amounts outstanding in sterling millions’, published 6 July 2010. 364 day usage figures taken from series YWQB7T published on the same date.

Source: *Bankstats*, Bank of England

- The asset purchase facility was first announced in January 2009. The main take up was over April 2009 to January 2010, at which point the scheme was suspended, with the Bank holding assets worth £200 billion. In practice, virtually all transactions under the scheme involved central bank purchases of government bonds (not clear from whom).³⁸
- Prior to this all schemes were “extended collateral long-term repos”;³⁹ here outstanding stock appears to remain at £50 billion.

Government schemes

Government schemes mimicked central bank operations, but with the taxpayer more directly involved and with systems often operating through the Debt Management Office.

- The *credit guarantee scheme* was announced in October 2008, it involved giving up to £250 billion in guarantees for bank and building society borrowing, again with the intention to revive markets for inter-bank lending (though in fact only about half of the facility was taken up). The government guaranteed new short-term and medium-term debt issuance to assist funding obligations. While the scheme was open from October 2008 to the end of 2009, associated debt could be rolled over until April 2012.

(Leaving aside Northern Rock and other smaller operations) the other main government schemes concerned the rescue of the Royal Bank of Scotland and Lloyds Bank Group. Under the recapitalisation schemes the government guaranteed debt and equity issuance. Under the *asset protection scheme* the government insured against losses on (or underwrote) very large amounts of assets. The operations led to the recording of both organisations as part of the public sector.

- Finally, the public await details of the operation of and activity under the *asset backed security guarantee scheme*.

The amounts involved are very difficult to summarise because of the different nature and terms of the schemes, and also because the scale of intervention under some schemes has not been revealed. The Bank of England has provided some useful information on the scale of intervention on all of the schemes. The readily available information has been summarised in Table 2.

GDP for 2009 was £1.4 trillion; the interventions amount to about 85 per cent of GDP, i.e. to a little short of one years' total economic output. Haldane and Piergiorgio also show an international comparison, with figures updated to November 2009.⁴⁰ Here UK intervention of 74 per cent of GDP compares with US intervention of 73 per cent and EU intervention of 18 per cent. More recent figures in the *Financial Stability Review* for December 2009 show UK at 74 per cent, the USA at 49 per cent and the EU at 30 per cent of GDP. (Note that for the UK these BoE estimates presumably do not include estimates for operations under the schemes where activity is not recorded.) Whatever the precise picture, it is clear that the UK has devoted a greater share of its national income to rescuing the financial sector than all other countries.

Table 2. The financial interventions

Scheme:	Window open:		Scheme closes:	Level of intervention £bn	Source of estimate
Special liquidity scheme	Apr-08	Jan-09	Jan-12	185	BoE market notice, 3/2/09
Discount window facility	Oct-08			50	Basically unknown; figure from ONS (see text)
Recapitalisation scheme				37	Widely reported
Credit guarantee scheme	Oct-08	end 2009	2014	125	DMO report, 29/3/10
Asset protection scheme	Jan-09			585	Widely reported
Asset purchase facility	Jan 09 to Jan 10			200	Widely reported
ABS guarantee scheme	Apr-09	Oct-09		Not known	Information unavailable
TOTAL				1182	

The nature of these interventions is not straightforward to grasp. Many of the schemes do not correspond to a cash payment for a very expensive good or service, though some operations did. Not all of the £1.2 trillion can be seen in the National Accounts assessment of the public sector finances.

This is because the transactions correspond to banking transactions: government activity now includes the provision of banking services on a colossal scale. In support, the Bank of England – to whom the traditional role of oversight and management of the financial system should fall – has extended its operations to an extent probably unknown in history. Nonetheless even these processes have seemingly been constructed so that government has underwritten most expenditure.

Banks provide all sorts of services, but their fundamental source of income and profit is interest revenue from lending. There may be strong arguments in favour of government providing such services under normal circumstances: the problem is that government has taken over banking systems that are in disarray. Events over the last few years show that the government can support the banking system in the short term, but it seems unlikely that it can turn bad lending into good. The taxpayer will have to foot the bill for that.

Moreover, the mysteries of the banking system are being exposed to public scrutiny, and the public might rightly ask what it is getting in return for its generosity.

The operations that the government have conducted could be applied to any industry. It could have supported Burberry or Dyson to prevent them leaving these shores. It could be building new industries such as wind farms. It could be creating credit to employ armies of new nurses and doctors. These are real questions.

Section 4.

Did it work?

*The lender must have sufficient confidence in the credit and solvency of the borrower... The borrower... must have sufficient confidence in the business prospects to believe that he has a reasonable prospect of earning sufficient return from a new investment proposition... Failing the restoration of confidence, we may easily have a vicious circle set up in which the rate of interest which the lender requires to cover what he considers the risks of the situation represents a higher rate than the borrower believes that he can earn. Nevertheless, there is perhaps not a great deal that can be done deliberately to restore confidence.*⁴¹

J.M. Keynes (1883–1946)

From the moment the crisis broke, the finance sector got its defence in first. The financial sector was not like other industries mentioned at the end of the last section; the survival of banks was prerequisite to the existence of modern economies. Treasury ministers in countless speeches went out of their way to celebrate the contribution of the financial sector. At his former Mansion House speech, the Chancellor proclaimed (somewhat ominously):

Together you have made London the world's main financial centre. And I agree with you, my Lord Mayor, that working in partnership, we must do everything to keep it that way.

In terms of the crisis, the prosperity of the finance sector and of the wider economy was portrayed as one and the same. The huge expenditure under intervention packages were justified as necessary to a revival of credit. In his Budget 2009 speech, Chancellor Alastair Darling claimed that “getting credit flowing again is the essential precondition to economic recovery”.

To prove that they meant business, the government set targets for bank lending and set up new processes to monitor the outcome. Box 5 contains an extract from Budget 2009.

Box 5. Lending commitments and actions

3.37 Action to ensure the stability of the financial system is a necessary precondition for economic recovery. The Government's responses are designed to support lending in the UK economy, an important part of supporting the economy through the downturn, and benefiting individuals and businesses.

3.38 Quantified and legally binding lending commitments will be agreed with banks accessing government support through the Asset Protection Scheme and the extended Credit Guarantee Scheme. Such lending commitments – on commercial terms and subject to market demand – have already been agreed with both RBS and Lloyds. RBS will lend an additional £25 billion on commercial terms over the 12 months from March 2009 – £9 billion of mortgage lending and £16 billion of business lending. Lloyds will lend an additional £14 billion on commercial terms over the 12 months from March 2009 – £3 billion of mortgage lending and £11 billion of business lending. Similar lending commitments have been made in respect of the subsequent 12 months and will be reviewed to ensure they reflect economic circumstances at that time. A robust monitoring framework has been put in place, and the Government will report to Parliament annually on the delivery of these agreements.

3.39 As described earlier in this chapter, on 23 February 2009 the Government announced that Northern Rock will undertake new lending of about £5 billion in 2009, and £3–9 billion a year from 2010 onwards, subject to market demand.

3.40 At the 2008 Pre-Budget Report, the Government announced the creation of a new Lending Panel to monitor lending to businesses and households and drive up standards of industry best practice in lending decisions. As part of this new monitoring approach, the Bank of England is publishing a monthly report – *Trends in Lending* – the first of which was published on 21 April 2009.

Source: UK Budget, 2009.

In fact, the decline in economic activity was arrested without any real revival in lending. From the second quarter of 2009, following the deepest decline in activity since the war, there was a very modest revival in economic growth. Moreover – in spite of the optimism of the newly created Office for Budgetary Responsibility – there are already widespread concerns that this ‘recovery’ is over. The recovery will be explored in the next chapter; this remainder of this chapter is concerned with the extent of any revival in lending.

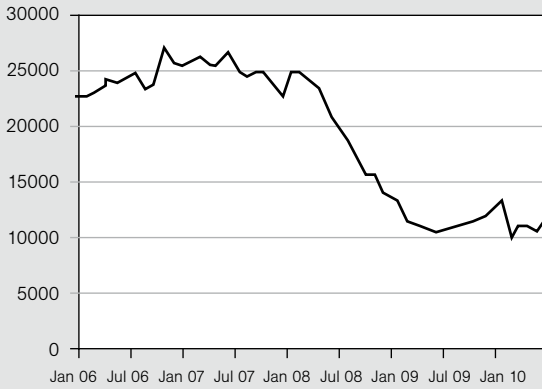
With each set of new lending data, the British Bankers Association (BBA) are invited onto the *Today* programme to defend themselves against the charge of not lending. Their refrain is that published figures refer to net lending rather than gross lending. Net lending figures are distorted because households and firms are repaying (or writing-off) debt. Gross lending measures would show that banks are indeed lending. Their refrain ends.

And it may be so, but there are difficulties:

- For households, gross lending is bumping along at a low level.
- For businesses, there is no aggregate information on gross lending in the public domain.
- Figures for small businesses show gross lending is in decline.
- Negative net lending is a failure in its own right (Section 5).

Figures 3 and 4 show gross mortgage lending and consumer credit. Plainly lending has not fallen to zero, but is continuing at a much lower level than before the crisis. There is little evidence of any revival in the growth of mortgage lending, though consumer credit has perked up marginally in recent months. It is not possible to assess performance against the targets, for individual bank data are not available, and it is not altogether clear how exactly the targets should be measured. However, the Lloyds and RBS targets look for an increase in lending from March 2009; on mortgages this has certainly not happened. Gross lending in March 2009 was £11.1 billion; in 2009/2010 it averaged £11.1 billion per month. Lending in other banks would have contracted severely if the state owned banks had met their targets.

Figure 3. Gross mortgage lending, £ million

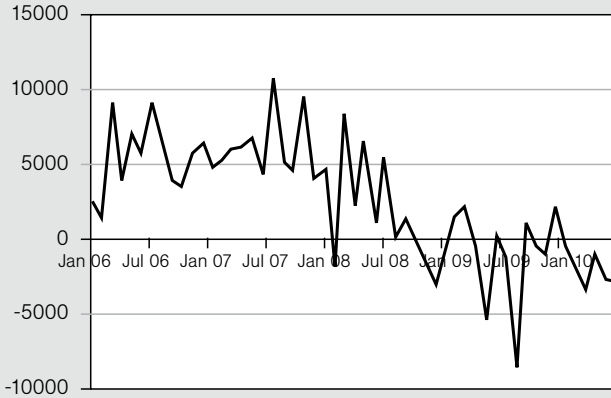


Source: Bankstats, code B3GF

Figure 4. Gross consumer credit, £ million



Source: Bankstats, code B3RA

Figure 5. Net lending to corporations, £ million

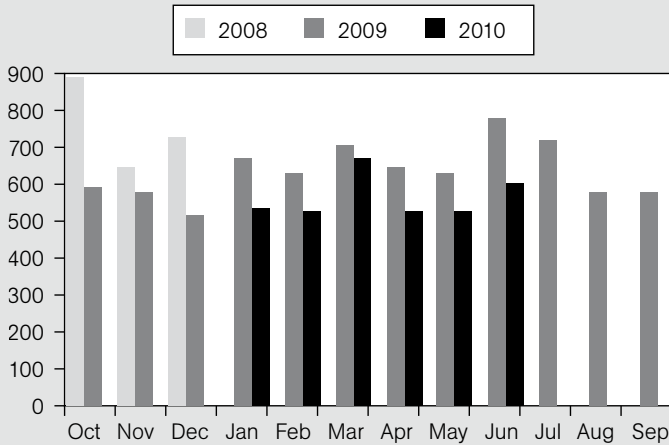
Source: Bankstats, VVOK

For businesses, as noted, there are no gross data. The net lending data are shown on Figure 5; monthly lending falls from around £6 billion in 2007 to a repayment of £2½ billion in 2010. Whatever the story on gross lending, overall the corporate sector activities funded by banks must be contracting to a quite substantial extent.

BBA themselves publish data for new lending to small businesses, which seemingly corresponds to gross lending. These show new lending in each month of 2010 below the same month in 2009: a monthly average of £564 compares with £664. The Statistics Director of the BBA offered this rather subdued assessment:⁴²

On a daily average basis, banks are making available around £27mn of new term lending to small businesses each working day. Over the past twelve months, nearly £7bn of new, long-term lending has been provided. The £46bn outstanding level of term loans and £8.5bn level of overdraft borrowing are remaining fairly stable: subdued volumes of new lending are offset by loan repayments from businesses seeking to reduce financing costs and reliance on borrowing by operating out of cashflow. In fact, over the last four months, small business deposits have grown by £2.5bn.

Figure 6. New term lending (& million) to small businesses



Source: British Bankers Association

And there, from the horse's mouth, we have it: there are "subdued volumes of new lending". New lending has stagnated.

What is not discussed on the *Today* programme is the role of interest rates in this sorry tale. A characteristic of financial crises is a rise in market rates of interest and in spreads between rates facing firms and businesses and government rates. The Bank of England has been rightly criticised for its inability to see the extent of the crisis; interest rates were only seriously cut from October 2008. The failure of Lehman Brothers was used to permit the change of policy without having to concede any previous failure; the conditions had simply changed.

The reduction in bank rate and in parallel quantitative easing did succeed in pulling greatly elevated interest rates back from the brink. However, market rates remain high relative to rates before the crisis. Bank rate may have been reduced to a historic low; the interest rates confronting households and businesses mean that monetary policy has scarcely been relaxed at all: basically, for many, interest rates are high.

Table 3. Change in interest rates affecting household borrowing

	Sept. 2008	June 2009	Change
Bank rate	5	0.5	-4.5
Overdraft	9.9	8.1	-1.8
Credit cards	17.7	18.5	+0.8
Fixed rate loans	9.6	10.2	+0.6
Deposits	3.1	0.8	-2.3

Source: Bankstats, Table G1.4

Table 3 shows how for most types of household borrowing, interest rates have hardly changed – and some have even increased – over the period of the major relaxation in monetary policy. The rate that has fallen the most is (surprise) the rate paid on deposits.

Mortgage borrowing is more difficult to assess because many of the mortgage products have been removed from the market, as banks insist on larger deposits. In the August 2010 *Inflation Report*, Chart 1.17 shows rates on a 90 per cent loan to value two year mortgage of about 6.5 per cent are now higher than the rate on a 95 per cent mortgage at the start of 2007 which was a little below 6 per cent.⁴³ So in spite of the requirement for a higher cash deposit, the interest rate is still higher.

Finally, rates on corporate borrowing are still harder to assess. Neither the Bank of England nor the ONS publishes any measures. The Bank of England does, however, make an assessment in its routine publications. The most telling figures are for spreads between corporate bonds and government bonds, which remain close to 2 per cent above the spreads before the crisis. A recent report by the Department for Business Innovation and Skills shows spreads over LIBOR for new bank loans to non-financial companies remain elevated.⁴⁴ The Bank of England sums up corporate loan pricing as follows:

*Previous editions of Trends in Lending have discussed the increase in spreads over reference rates on new facilities since the start of the financial crisis. To some extent, elevated spreads reflect heightened credit risk and a repricing of risk. But they are also likely to reflect the relatively high cost to banks of raising longer-term funding.*⁴⁵

So – across the board – higher interest rates have prevailed; these have at root cause the failure of the banking system.

This takes us back to Keynes's assessment cited at the head of this section. Lending is subdued because interest rates are high; borrowers – acutely aware of their own indebtedness, no doubt – can scarcely afford to borrow. In spite of intervention on a colossal scale, confidence has not been restored. It is curious that in the wake of the rescue of the banking system, even the most commonplace wisdoms have been set aside; every economist has understood that 'you can lead a horse to water but cannot make it drink'; Keynes was more colourful 'extending the money supply to foster recovery is like trying to get fat by buying a bigger belt' [to paraphrase]. Banks cannot force people to borrow; injecting money into an economy does not necessarily lead to a resumption of lending. Lending has not resumed on the scale necessary for economic recovery. But we should have expected nothing else.

Box 6. The lending dilemma – how to help small businesses

The banks stand accused of not lending to the UK's small and medium-sized enterprises (SMEs). Banks claim it is not their fault: they say they are granting about two-thirds of all facilities that are being requested. If, as they claim, many small businesses are not using the facilities they've been granted then that's not the banks' fault. Or so they say. The reality is, of course, much more complex than the debate suggests.

The first and most important point to note is that when the government is seeking to cut costs with the expectation and likely result that up to 1.5 million jobs could be lost – half each in the public and private sectors – it

is wholly irrational for any small business to be taking risks. The last thing business will be wanting to do right now is invest, take on people, expand, use up lines of credit, or in any way take action that might prejudice its potentially already slim chances of survival. So of course SMEs are not asking to borrow right now – and that is the fault of the spending and economic contraction stemming from government policy.

Second, that also explains the reason why by no means all of the bank facilities that have been granted are being used.

Third, it would be particularly worrying if most of most facilities that had been granted were being used. If the term ‘facility’ here is being used to mean the part of an agreed overdraft limit that is being drawn down at any time then it is encouraging that many are not being drawn upon. Overdrafts are perfectly sensible things for small businesses to have, but they are meant to provide short-term liquidity to cover the peaks and troughs of cash flow, and are not long-term funding. If all small businesses were at their overdraft limits then, in all likelihood, we’d soon be facing a round of insolvencies. Even if we’re not, this also means that the banks’ excuse for customers not using their funding is at the very least disingenuous.

So what is the problem? First of all, without a shadow of a doubt small business is feeling very vulnerable in the face of an impending double-dip recession – from which there may be little chance of recovery for a long time.

Second, quite a lot of new small businesses may be decidedly marginal i.e. they are being registered simply because their owners cannot claim benefits and have no prospect of finding other work, so they seek self-employed income in whatever amount they can get it as the next best thing. There is no doubt that this is happening, but such ‘last resort’ activity is not something to encourage bank confidence, quite understandably, and does almost certainly distort lending ratios.

Third, and by far the most important, is to look for the wrong solution to the problem of small business funding. The sort of lending banks have offered UK small business has always been inappropriate, costly, and largely ineffective in encouraging this sector. It is the surest indication of the business inexperience

of those in government that they have no idea that this is the case and that they really believe the banks' advertisements that say those organisations are a source of finance and advice to small business. They are not; they lack the necessary skills, knowledge, and experience.

This needs explanation. Why would anyone think a bank can help a small business? People working in banks are far removed from the world of the smaller scale, successful entrepreneur. A chasm exists between them and the entrepreneur which is virtually unbridgeable when it comes to offering advice. And it is this lack of comprehension on the part of bankers of the SME community that has meant that banks often just don't offer what small business needs.

What banks offer is the type of lending that suits bankers' personalities – so they offer lending against the security of assets repayable in nice equal amounts, when in the knowledge economy there won't be many assets suitable for this task and cash flow is lumpy. And banks want to lend for liquidity through overdrafts secured on assets when what small businesses really need is capital that can be subject to risk.

This mismatch is large, and a general failing of Anglo Saxon capitalism, not a mismatch of this moment in time. The government does not appear to understand that, nor do the banks. Those meant to champion business in government don't seem to either. And the accountancy bodies are not saying much. They just talk tax avoidance and offer the rhetoric of being opposed to regulation, which has never solved the problem of a shortage of capital.

So the government is right – there is a problem of small business lending. But the solution is for it to reinvigorate the economy. And the government is right – there is a problem of a lack of appropriate bank lending, but this is a systemic fault, not a temporary one, and only a change in culture is likely to address it.

The required change of culture by banks is, however, as radical as that required of this government right now if it is to stop cutting, and to reinvigorate the economy instead so that business has a reason to invest.

If both can have these changes of culture, what is needed, in essence, is that the government in partnership with the banks and others has to create the mechanism to invest capital in businesses that need it.

How does this happen? There are three mechanisms. First, direct tax incentives – especially for new socially desirable businesses that can create jobs such as those linked to green energy – have to be offered.

Second, a more flexible structure for apportioning reward in small businesses than the rigid forms of capital required by small limited companies, have to be developed. While the basis for this is available in the limited liability partnership, the understanding of its use is not present as yet. Real thinking on how to move the corporate entity into the twenty-first century and out of the nineteenth to which it is still wedded is needed. . . now. Only then can the partnership relationships where banks can, for example, subscribe for variable and repayable equity in businesses without assuming liability for management as well be created.

Third, banks, the government, local authorities, and pension funds have to combine to create small enterprise funds that direct savers money into creative enterprise – which is not done at present.

And finally, any tax-based incentive schemes – such as ISAs – have to be made conditional on the funds invested being used for real investment in real businesses that the economy needs – such as new goods, services, and infrastructure for a low-carbon transition – and not for leaving funds on deposit or to be saved in the second-hand shares of large companies.

All of this is possible – and banks have a role to play in it. Indeed, this is the perfect role for a Green Investment Bank or the Royal Bank of Sustainability. But the real onus to achieve this is on the government. It is the government who has to create the environment in which the demand for banks' constructive role in society exists once more. And that can only happen if it changes the infrastructure for providing capital to small business in the UK.

Box 7. Where have all the branches gone?

The economics of running a major retail network in the UK no longer stack up.

Michael Geoghegan, HSBC Chief Executive, 22 May 2009

The pattern of retail banking in the UK has been one of steadily reduced competition, and ever-increasing homogeneity on the high street. This process accelerated after the ‘big bang’ reforms of the 1980s, and in the wake of the credit crunch has accelerated again. The merger of Lloyds-TSB and HBOS, and the takeover of Alliance and Leicester, Abbey, and parts of Bradford & Bingley by Santander left power further concentrated in the hands of a very few, very big, banks.

These few big banks operate at an ever-more profitable distance from their customers, thanks to new, automated techniques such as credit scoring. Staff with direct knowledge of borrowers have been shed in favour of computerised systems able to deliver more ‘efficient’ computer ratings.

According to the Campaign for Community Banking, the number of bank branches in the UK is now just 9094 – 43 per cent less than just 20 years ago.⁴⁶ The UK has 197 bank branches per million inhabitants (including building societies). This compares with over 500 branches per million inhabitants in Germany and 1010 branches per million inhabitants in Spain.⁴⁷ Not only does Spain have more banks per head of population, they are also far better disbursed than they are in the UK.

Headline figures on the numbers of bank branches in the UK don’t give the full picture. For many of the 1500 rural and suburban communities that have only one or two bank branches left, even those branches may only be open for one or two days a week.

Neither is it just a question of access for individuals. Access to banking is key to the survival of retail and other services in many medium-sized rural communities and in less well-off suburbs, estates, and inner cities. If active people and small businesses go to bank elsewhere, they are likely to spend

elsewhere, too. Those that suffer most from the loss of local amenities are the most vulnerable: older and disabled people, those with mobility difficulties, and carers.

And, when we find a branch that is still open, there are fewer people to deal with any queries we have. Figures from the British Bankers Association (BBA) show that in the five years from 2003, Abbey reduced its staff numbers by 12,897, Lloyds TSB cut 15,058 staff, and the Royal Bank of Scotland, 11,200. Since the BBA data was compiled, Lloyds TSB announced plans to make 11,000 more staff redundant and RBS announced plans for a similar number of cuts.⁴⁸

Section 5.

Into the present

A brief fiscal interlude

In terms of the economic crisis, monetary policies did succeed in pulling interest rates from the severe rises at the height of the crisis. But there has been no growth in lending to support a recovery in household or business demand. Instead the impetus for the modest recovery in growth has come from government demand and associated policy.

Government final consumption and investment expenditure have increased throughout the crisis, even up to the present. In addition, the government announced a number of special measures in the *Pre-Budget Report 2008* and *Budget 2009*, aimed at reviving consumer and business demand. These echoed actions taken by governments around the world. Notable interventions were as follows:

- Increase in personal tax allowances (2008/2009: £2.6 billion)
- VAT reduction (2008/2009: £3.8 billion; 2009/2010: £8.6 billion)
- Allowing a higher proportion of private investment expenditures to be offset against tax (2009/2010: £1.6 billion)
- Vehicle ‘scrappage’ scheme (2009/2010: £300 million)
- Strategic investment fund, support for advanced industrial projects of strategic importance (2009/2010: £400 million).

The measures plainly impacted economic growth. But, across the world, the impact appears to have been short-lived and moreover has made little impact on highly elevated levels of unemployment. At the time of writing, the Central Bankers, meeting at Jackson Hole in the USA, are warning of the likelihood of the ‘double dip’ and preparing markets for further monetary interventions.

There is little discussion of the synergy between certain monetary and fiscal actions. In 2009, quantitative easing supported fiscal policy. Government borrowing was financed by the issue of bonds; under quantitative easing, the Bank of England effectively purchased

these bonds (in a roundabout and unnecessarily expensive manner, seemingly because of EU legislation that forbids the ‘monetisation’ of government debt). The scale of the deficit was very similar to the scale of quantitative easing activity. The final section of this report looks at the Green New Deal approach to these operations.

Banks in profit but the ‘funding cliff’ looms

While the macroeconomic benefits of the financial interventions may not be apparent, the banks themselves have seen some improvement in their position. Over the summer, there were a series of announcements of interim results for 2010 (Table 4). Barclays and HSBC record the highest (post-tax) profits, though some reduction over the second half of 2009. Lloyds and RBS have scraped a return to profit, and the smaller operations appear to be reasonably profitable given the smaller balance sheets.

In the press there was naturally some bemusement about these figures, and comment about how actions to restore healthy profits were seemingly at odds with the interests of the wider populations:

- as seen in Section 4, banks have increased spreads between loans and deposits;
- they have increased fees;
- they have increased the size of deposits required for mortgages, and scrapped a number of schemes (such as tracker loans);

Table 4. Banks’ post-tax profits

	Total assets /liabilities (trillion)	Profit: half year to 30 June 2010 (billion)	Profit: half year to 31 Dec 2009 (billion)	Profit: half year to 30 June 2009 (billion)
Barclays (£)	1.6	2.9	8.0	2.3
HSBC (\$)	2.4	5.3	11.8	9.0
Lloyds (£)	1.0	0.7	(4.2)	7.2
RBS (£)	1.6	0	N/A	(1.0)
Santander (£)	0.3	0.9	0.8	0.7
Nationwide (£)	0.2	0.26 [2010]	0.15 [2009]	

Source: Interim results announcements for the 6 months to 30 June 2010 as released by each bank to the Regulatory News Service (RNS) of the London Stock Exchange.

Table 5. Banks net lending (M4 lending, changes in amounts outstanding), £ billion

	Businesses	Households	Total
2008 Q4	-5.8	10.5	4.6
2009 Q1	3.4	6.0	9.5
Q2	-6.9	4.8	-2.2
Q3	-8.8	4.3	-4.5
Q4	-0.0	6.2	6.2
2010 Q1	-6.7	4.1	-2.6
Q2	-7.7	2.1	-5.5

Note: M4 is a measure of money supply published by the Bank of England.

Source: *Bankstats*, Table A4.3

- they have shut branches and sacked staff; and
- they have reduced impairment charges for bad lending.

In terms of balance sheets, the UK private sector is repaying more debt to the banks than the banks are lending. Table 5 summarises the flows of net lending: over the past five quarters, net lending was positive only once; the latest quarter showed the highest repayment of lending on record. (If lending to other financial corporations was included, the position would be much worse.)

This is an astonishing reversal. Moreover, to support this contraction in banking facilities, the banks are still relying to a great extent on securitisation. Unfortunately, but perhaps unsurprisingly, details of these operations are very sketchy. The latest annual reports offer various information and quantifications, but in general the extent of securitisation is not obvious, nor is the extent to which and how these operations are held off balance sheet.

- Lloyds Banking Group provides the most information. Notes 12 and 17 to the balance sheet in the interim annual report indicates a recorded £65 billion liability which covers the difference between £283 billion of ‘gross securitised assets’ and ‘notes in issue’, suggesting a reliance on funding of £218 billion (down from £226 billion at the end of 2009).⁴⁹

- RBS includes estimates for securitisations and conduits of £110 billion (virtually the same as end 2009).⁵⁰ Nationwide reports a total of £72 billion of ‘securitised and covered bonds’ (up £5 billion from 2009).⁵¹
- The latest reports for Barclays, Santander, and HSBC show very little information on these activities.

The funding gap

As these figures indicate, while the financial interventions have supported securitisation processes, there has not been any significant reduction in the overall reliance on these processes. Looking to the future, not only will public schemes close, but the maturity structure of the funding means that banks will increasingly be looking to inter-bank markets.

In the overview of its August 2010 *Inflation Report*, the Bank of England warns: “UK banks continue to face a number of challenges related in particular to their need to refinance substantial levels of maturing funding”.⁵²

The Bank discussed matters in more detail in its June 2010 *Financial Stability Report*. Taking into account the maturity structure and the withdrawal of public schemes they calculate:

*... the major UK banks will need to refinance or replace around £750 billion to £800 billion of term funding and liquid assets by end-2012. On a straight-line basis, that would imply over £25 billion would need to be raised every month for the next two and a half years. This is significantly ahead of the £12 billion average monthly public issuance so far this year, or the monthly run-rate between 2001 and 2007 (around £15 billion).*⁵³

This increase is known as the funding ‘gap’ or ‘cliff’, though the precise monthly figures and timings cannot be derived easily. The problems are faced by a number of major economies, though Bank evidence shows that the problems are *particularly acute for the UK in 2011* (interestingly US requirements are significantly lower).⁵⁴

Banks are not entirely oblivious to these considerations and their ongoing reliance on largescale securitisation. Their annual reports include strategies to reduce this reliance. Lloyds is typical: “Over the next four years, we expect the combination of customer deposit growth and balance sheet reduction to significantly reduce the Group’s wholesale funding requirement”.⁵⁵

While the Bank of England notes that it is working with the banks, in a summary passage it is fairly scathing about these strategies:

There is a risk that, in aggregate, banks' funding plans make optimistic assumptions about system-wide deposit growth and envisage reductions in lending that suggest tight credit conditions...⁵⁶

Really, the Bank's analysis is feeble. First, lending creates deposits, so the plans ignore the basic principles of banking. Banks are therefore relying on re-allocation of asset portfolios; it does not explain how and why this strategy might work (higher interest rates presumably), nor why all banks can compete successfully for a piece of this action. Moreover, the Bank's own solution seems rather wistful:

Increased efforts to retain higher capital, by limiting discretionary distributions to shareholders and staff while profits are stronger, would help banks to build resilience and prepare for Basel III while sustaining lending to companies and households.⁵⁷

No matter how essential an end to bonuses and excessive pay in the City may be, it seems unlikely that such an approach will be adequate to restore the financial system to health.

Let us be quite clear. In order to support a banking system that is in aggregate withdrawing lending from the private sector, UK banks currently have to borrow £12 billion a month. In 2011, they will have to borrow an additional £13 billion a month. It seems unlikely that under such circumstances the economy will see an improved service from the banking system over this period. Indeed the taxpayers should be bracing themselves to provide the additional loans.

Moreover, there are other risks to the system, not least from commercial property. BIS shows that "UK banks entered the recession with loans to the UK commercial property sector accounting for almost half [£250 billion] of all the outstanding loans to UK businesses [£425 billion], which in turn fuelled a rapid increase in asset prices in the UK."⁵⁸

The banking system, and all its marvels, has been stood on its head. It is riddled with bad debt and has become a borrowing machine, not a lending machine. This is the economics of a lunatic asylum.

Section 6.

The government and the banks

*Yet there is one key difference between the situation today and that in the Middle Ages. Then, the biggest risk to the banks was from the sovereign. Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.*⁵⁹

A. Haldane and P. Alessandri

The discussion so far has focused primarily on the financial sector. But as we all are becoming increasingly aware, the impact of the failure is being felt across the whole economy. In particular, public finances have deteriorated with the crisis. With the economy reliant on finance to an extreme extent, tax revenues collapsed with the finance sector. As unemployment has risen, tax revenues have declined further and benefit payments have increased. The increase in public sector borrowing and debt has then been exacerbated by financial sector interventions. (These do not map one-to-one to the public sector finances, as discussed at the end of Section 2.)

Yet, in a sleight of hand of breathtaking audacity, the government has passed the blame for the crisis from the financiers to the public sector. Public sector finances have deteriorated because of underlying structural weaknesses in the economy, rather than because of its excessive reliance on finance. While the quote at the head of this section indicates that Andrew Haldane, the Executive Director of Financial Stability at the Bank of England, recognised the true causality, this has not been accepted by politicians.

Rather than regard finance as broken, the politicians have chosen to regard government as broken. New Labour set out a blueprint for an assault on the state; the Coalition has merely intensified this assault. The financial sector demanded a fiscal consolidation, and the Government has pledged itself to deliver. The ease with which our politicians have attacked civil servants and the social benefits that have been the birthright of UK citizens since the Second World War contrasts markedly with an almost non-existent approach (so far) to financial sector reform.

Box 8. Sir John Vickers and the Independent Commission

HMT offer the following biography:

Sir John Vickers is Warden of All Souls College, Oxford. He was educated at Oriel College, Oxford. From 1991 to 2008 he was Drummond Professor of Political Economy at the University of Oxford. He was Chief Economist of the Bank of England and served on the Bank's Monetary Policy Committee from June 1998 to September 2000, and then head of the Office of Fair Trading until 2005.

Sir John was also the Chairman of the Royal Economic Society from 2007 to 2010, as the financial crisis unfolded. The other Commission members are:

- **Bill Winters**, formerly of JP Morgan
- **Sir Martin Taylor**, former CEO of Barclays
- **Martin Wolf** of the *Financial Times*
- **Clare Spottiswoode**, former Chief Executive of OFGEM, the gas regulator.

Looking ahead, the Coalition government's main strategy for financial reform has been to set up an independent commission on Banking, under Sir John Vickers (Box 8).

The watchword of the enquiry is already COMPETITION. A BIS report on lending to small businesses notes that the commission has been set up to “investigate ways of improving stability and competition in the banking system”.⁶⁰ Vickers and Spottiswoode are competition economists; there are no monetary economists, no representatives of industry, households, or unions. To regard competition as a solution is a very standard and cynical approach to a failure of deregulation; to regard the financial sector as amenable to standard competition economics is to reveal the extent to which the finance sector is not understood, or not permitted to be understood.

The public is already paying a heavy price for the failure of the financial sector. When the impact of the consolidation comes through, the price will be heavier still. It seems unlikely that the price will be worth paying.

A question of influence

Some have questioned the extent of the influence of the finance sector over the government. In the USA, Simon Johnson, a former Chief Economist of the IMF, is categorical (Box 9).

Box 9. From *The Quiet Coup* – Simon Johnson, former Chief Economist at the International Monetary Fund (extract from an article published in *The Atlantic*, May 2009)

... Elite business interests—financiers, in the case of the U.S.—played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed, and fast, to pull the economy out of its nosedive. The government seems helpless, or unwilling, to act against them.

Top investment bankers and government officials like to lay the blame for the current crisis on the lowering of U.S. interest rates after the dotcom bust or, even better—in a “buck stops somewhere else” sort of way—on the flow of savings out of China. Some on the right like to complain about Fannie Mae or Freddie Mac, or even about longer-standing efforts to promote broader homeownership. And, of course, it is axiomatic to everyone that the regulators responsible for “safety and soundness” were fast asleep at the wheel.

But these various policies—lightweight regulation, cheap money, the unwritten Chinese-American economic alliance, the promotion of homeownership—had something in common. Even though some are traditionally associated with Democrats and some with Republicans, they all benefited the financial sector. Policy changes that might have forestalled the crisis but would

have limited the financial sector's profits—such as Brooksley Born's now-famous attempts to regulate credit-default swaps at the Commodity Futures Trading Commission, in 1998—were ignored or swept aside.

The financial industry has not always enjoyed such favored treatment. But for the past 25 years or so, finance has boomed, becoming ever more powerful. The boom began with the Reagan years, and it only gained strength with the deregulatory policies of the Clinton and George W. Bush administrations. Several other factors helped fuel the financial industry's ascent. Paul Volcker's monetary policy in the 1980s, and the increased volatility in interest rates that accompanied it, made bond trading much more lucrative. The invention of securitization, interest-rate swaps, and credit-default swaps greatly increased the volume of transactions that bankers could make money on. And an aging and increasingly wealthy population invested more and more money in securities, helped by the invention of the IRA and the 401(k) plan. Together, these developments vastly increased the profit opportunities in financial services.

Not surprisingly, Wall Street ran with these opportunities. From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits. In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent. Pay rose just as dramatically. From 1948 to 1982, average compensation in the financial sector ranged between 99 percent and 108 percent of the average for all domestic private industries. From 1983, it shot upward, reaching 181 percent in 2007.

The great wealth that the financial sector created and concentrated gave bankers enormous political weight—a weight not seen in the U.S. since the era of J.P. Morgan (the man). In that period, the banking panic of 1907 could be stopped only by coordination among private-sector bankers: no government

entity was able to offer an effective response. But that first age of banking oligarchs came to an end with the passage of significant banking regulation in response to the Great Depression; the reemergence of an American financial oligarchy is quite recent.

...

One channel of influence was, of course, the flow of individuals between Wall Street and Washington. Robert Rubin, once the co-chairman of Goldman Sachs, served in Washington as Treasury secretary under Clinton, and later became chairman of Citigroup's executive committee. Henry Paulson, CEO of Goldman Sachs during the long boom, became Treasury secretary under George W. Bush. John Snow, Paulson's predecessor, left to become chairman of Cerberus Capital Management, a large private-equity firm that also counts Dan Quayle among its executives. Alan Greenspan, after leaving the Federal Reserve, became a consultant to Pimco, perhaps the biggest player in international bond markets.

These personal connections were multiplied many times over at the lower levels of the past three presidential administrations, strengthening the ties between Washington and Wall Street. It has become something of a tradition for Goldman Sachs employees to go into public service after they leave the firm. The flow of Goldman alumni—including Jon Corzine, now the governor of New Jersey, along with Rubin and Paulson—not only placed people with Wall Street's worldview in the halls of power; it also helped create an image of Goldman (inside the Beltway, at least) as an institution that was itself almost a form of public service.

Wall Street is a very seductive place, imbued with an air of power. Its executives truly believe that they control the levers that make the world go round. A civil servant from Washington invited into their conference rooms, even if just for a meeting, could be forgiven for falling under their sway. Throughout my time at the IMF, I was struck by the easy access of leading financiers

to the highest U.S. government officials, and the interweaving of the two career tracks. I vividly remember a meeting in early 2008—attended by top policy makers from a handful of rich countries—at which the chair casually proclaimed, to the room’s general approval, that the best preparation for becoming a central-bank governor was to work first as an investment banker.

A whole generation of policy makers has been mesmerized by Wall Street, always and utterly convinced that whatever the banks said was true. Alan Greenspan’s pronouncements in favor of unregulated financial markets are well known. Yet Greenspan was hardly alone. This is what Ben Bernanke, the man who succeeded him, said in 2006: “The management of market risk and credit risk has become increasingly sophisticated. . . . Banking organizations of all sizes have made substantial strides over the past two decades in their ability to measure and manage risks.”

Of course, this was mostly an illusion. Regulators, legislators, and academics almost all assumed that the managers of these banks knew what they were doing. In retrospect, they didn’t. AIG’s Financial Products division, for instance, made \$2.5 billion in pretax profits in 2005, largely by selling underpriced insurance on complex, poorly understood securities. Often described as “picking up nickels in front of a steamroller,” this strategy is profitable in ordinary years, and catastrophic in bad ones. As of last fall, AIG had outstanding insurance on more than \$400 billion in securities. To date, the U.S. government, in an effort to rescue the company, has committed about \$180 billion in investments and loans to cover losses that AIG’s sophisticated risk modeling had said were virtually impossible.

Wall Street’s seductive power extended even (or especially) to finance and economics professors, historically confined to the cramped offices of universities and the pursuit of Nobel Prizes. As mathematical finance became more and more essential to practical finance, professors increasingly took positions as

consultants or partners at financial institutions. Myron Scholes and Robert Merton, Nobel laureates both, were perhaps the most famous; they took board seats at the hedge fund Long-Term Capital Management in 1994, before the fund famously flamed out at the end of the decade. But many others beat similar paths. This migration gave the stamp of academic legitimacy (and the intimidating aura of intellectual rigor) to the burgeoning world of high finance.

As more and more of the rich made their money in finance, the cult of finance seeped into the culture at large. Works like Barbarians at the Gate, Wall Street, and Bonfire of the Vanities—all intended as cautionary tales—served only to increase Wall Street's mystique. Michael Lewis noted in Portfolio last year that when he wrote Liar's Poker, an insider's account of the financial industry, in 1989, he had hoped the book might provoke outrage at Wall Street's hubris and excess. Instead, he found himself "knee-deep in letters from students at Ohio State who wanted to know if I had any other secrets to share. . . They'd read my book as a how-to manual." Even Wall Street's criminals, like Michael Milken and Ivan Boesky, became larger than life. In a society that celebrates the idea of making money, it was easy to infer that the interests of the financial sector were the same as the interests of the country—and that the winners in the financial sector knew better what was good for America than did the career civil servants in Washington. Faith in free financial markets grew into conventional wisdom—trumpeted on the editorial pages of The Wall Street Journal and on the floor of Congress.

From this confluence of campaign finance, personal connections, and ideology there flowed, in just the past decade, a river of deregulatory policies that is, in hindsight, astonishing:

- *insistence on free movement of capital across borders;*
- *the repeal of Depression-era regulations separating commercial and investment banking;*

- *a congressional ban on the regulation of credit-default swaps;*
- *major increases in the amount of leverage allowed to investment banks;*
- *a light (dare I say invisible?) hand at the Securities and Exchange Commission in its regulatory enforcement;*
- *an international agreement to allow banks to measure their own riskiness;*
- *and an intentional failure to update regulations so as to keep up with the tremendous pace of financial innovation.*

The mood that accompanied these measures in Washington seemed to swing between nonchalance and outright celebration: finance unleashed, it was thought, would continue to propel the economy to greater heights.

...

By now, the princes of the financial world have of course been stripped naked as leaders and strategists—at least in the eyes of most Americans. But as the months have rolled by, financial elites have continued to assume that their position as the economy's favored children is safe, despite the wreckage they have caused.

In the UK, the editor of the journal *Central Banking* was equally categorical in a hard-hitting leading article:

Notwithstanding improvements in the functioning of money markets and signs of economic recovery, leading developed country central bankers remain extremely pessimistic about the underlying financial and economic situation. While they were engaged in fire-fighting, during the critical phase of the banking crash in 2007–08, they were driven by events to use all weapons at their disposal – and hastily develop some new ones – in their efforts to limit the damage. Now, they are uneasily aware that despite the enormous cost of the episode to the public purse, few of its basic causes have been addressed.

The basic reason for this, expressed more in private rather than in public, is that they can see no way of restoring sufficient discipline in the financial system so long as governments are unwilling to stand up to the financial lobby. Governments have shown they have no stomach for this fight. Rather than use the crisis to reform the structure of banking and finance, they are looking to better regulation to solve the problem. Yet leading central bankers doubt that regulation can fix the broken banking and financial system. Regulatory tools were there pre-crisis, but were not used.

This goes beyond the well-known phenomenon of “regulatory capture”. It is a matter of the influence of private financial interests over policy making at the highest levels of government.⁶¹

These are hardly radical voices; they are voices of those with expertise in and long-standing experience of the financial sector.

Plainly the fiscal consolidation has been demanded of governments by the financial sector. The government – supported by economists such as Kenneth Rogoff – argue that government debt can go no higher than a certain ratio of GDP (conveniently, 100 per cent). Otherwise, we are warned, it will not be possible to issue further government bonds. However there are rumours that the financial sector wants to reduce public sector borrowing simply to make room for the next intervention. These were hardly quashed by Jean-Claude Trichet’s remarks in a recent *Financial Times* debate on the topic of fiscal consolidation:

... systemic economic stability – and therefore sustainable growth – relies on the ultimate capacity of public finances to intervene in difficult circumstances. Fiscal buffers are essential when our economies are in a typical business cycle. They are even more necessary when our economies are coping with exceptional circumstances. Had our public finances not been credible when that 27 per cent of GDP [NB a serious underestimate] of taxpayer risk was mobilised, we would not have avoided a financial meltdown and a second Great Depression. We are doing all that is possible to avoid a future economic catastrophe resulting from the extreme malfunctioning of the financial sector. And I am convinced that we will succeed. But even with the best G20 financial reform there may be many different triggers for economic and financial dislocation. Other unexpected events, including natural catastrophes, may need emergency fiscal support. Sound public finances are a decisive component of economic stability and sustainable global growth.⁶²

Section 7.

A new financial operating system and a Green New Deal

For the financial sector, its own prosperity and public sector austerity are the remedy for the crisis. Yet the evidence of the past three years suggests that, at the least, they are not a cure, and could make things much worse. The financial sector is in profit but the economy has not benefited; indeed it is sucking money from the economy. In the meantime any recovery in GDP has been driven by direct government intervention, admittedly of a hardly ideal nature.

Three bastions of the establishment suggest that the superstructure of the market and financial system is fatally fractured. That indicates it is time for politicians to lose their timidity and start building a new one, and to stop trying to rebuild the old, failed one.

Mervyn King of the Bank of England says that the “massive support extended to the banking sector around the world . . . has created possibly the biggest moral hazard in history”.⁶³ Lord Stern, former Chief Economist at the World Bank says that “climate change is a result of the greatest market failure that the world has seen”.⁶⁴ And, the economic godfather of them all, Alan Greenspan, former Head of the United States Federal Reserve comments that “I made a mistake in presuming that the self-interest of organisations, specifically banks, is such that they were best capable of protecting shareholders and equity in the firms.”⁶⁵

Put these three observations together, and a number of logical conclusions emerge. First is that action taken so far to apply financial balm to the banking crisis, whilst temporarily avoiding total collapse of the system, may actually have made things worse, storing up nastier problems for later. One particularly nasty rumour is that the scale of the current cuts in public services is partly dictated by the Coalition government’s covert provisioning against the need to bail out the banks again, in the not too distant future. Second is that, obsessed with the fiscal deficit, we are down playing the greater, life threatening significance of our ecological deficit. With better data and measurement methods we learnt recently that this year humanity went into

ecological debt a month earlier, on 21 August, having consumed far more resources and produced more waste than ecosystems can provide and absorb.

Lastly, we learned, from Greenspan, senior architect of global banking, that “the critical functioning structure that defines how the world works,” was based on a flawed presumption.⁶⁶ With some candour, he admitted: “I have been very distressed by that fact.” The significance of this admission is that he is the man who was a prime force behind abolishing the famed Glass-Steagall Act, which separated retail and investment banking after the 1930’s financial crisis, and who was a cheerleader for deregulation and credit-fuelled economic growth.

Altogether, these insights take us to a destination that many will find intimidating, but it is a journey we must embark upon if we are to have the remotest chance of preventing further economic chaos and, for that matter, the drift towards a catastrophically destabilised climate. We must seize this opportunity to build a new ‘critical functioning structure’ that does a vastly better job for people and the planet.

The way that banking functions creates a kind-of operating system for the rest of the economy. If bad design creates a tendency for excess and collapse, that will be mirrored in the wider world, and has been.

Even when **nef** published the *Green New Deal* in summer 2008, the need to reform the banking system was identified as a precondition of tackling the numerous other challenges of building energy and food security, addressing climate change, peak oil and the recession.

Box 10. The Royal Bank of Scotland (RBS)

What can the government do with nationalised banks: fossil fuel investment and funding low-carbon transition

For many institutional investors, climate change is rapidly becoming as relevant a factor on an investment decision as more traditional financial elements such as liquidity or competition... across the world investment managers... and the global investment community are increasingly aware they must take climate change into account as part of a holistic approach to fiduciary duty.

Principles for Responsible Investment,
United Nations, 2006

The oil and gas bank

The Royal Bank of Scotland used to advertise itself as an 'oil and gas bank'. Although it no longer does, rising awareness of climate change has done little to alter its enthusiasm for the sector. Now in public ownership, the government has not used its control to re-orient its lending to more sustainable and growing sectors, such as renewable energy. Since RBS was bailed out by the taxpayer on 13 October 2008, RBS has provided nearly £13 billion worth of funding to the oil and gas industries.

According to figures from financial information company Bloomberg published by PLATFORM, RBS directly loaned nearly £3.6 billion to fossil fuel companies and helped to raise equity finance worth £9.3 billion.

The 66 companies backed by RBS include BP, Shell, Conoco Philips, Tullow Oil, Trafigura, and Cairn Energy. RBS has helped them raise hundreds of millions of pounds to finance oil exploration, extraction, and development around the world. The US oil giant Conoco Philips accessed £917 million with RBS support, Shell leveraged £909 million, while BP was able to access £633 million.

- RBS also helped the British-based multinational Tullow Oil raise £448 million. The oil firm's activities in both Uganda and the Democratic

Republic of Congo have been the subject of criticism. Production of up to 200,000 barrels of oil a day is scheduled to start soon in one of Uganda's most environmentally sensitive areas.

- RBS helped the controversial London-based oil trader Trafigura raise £210 million. In July 2010, the company was fined the equivalent of £840,000 by a court in the Netherlands for illegally exporting toxic waste which allegedly made 30,000 people ill on the Ivory Coast in West Africa.
- There is also concern over drilling off Greenland being carried out by Edinburgh-based Cairn Energy. The company received £117 million in loans and equity from RBS in 2009. Almost half of that directly helped it start exploratory drilling off Greenland in July this year. Greenland is frontier territory for the oil industry because it hasn't been exploited before. But as well as potential wealth, it will inevitably bring new environmental risks, all too obvious since BP's disaster at the Deepwater Horizon well in the Gulf of Mexico.

The case for a different course of action

In June 2009, campaign groups⁶⁷ filed a judicial review against the government. They believed that the Treasury had breached its own *Green Book* guidance in managing its majority share in RBS through UK Financial Investments Ltd, the body set up to manage the governments share in the nationalised banks.

The Treasury's *Green Book* provides binding guidance for all government departments, requiring government to make an 'assessment' of its policies, programmes, and projects to ensure that public funds are spent on activities that provide the greatest benefit to society and that they are spent in the most efficient way. According to the *Green Book* an assessment should consider the environmental impact of any decision.

During the course of the legal proceedings, in a letter to the Claimants' solicitors on 10 February 2010, UKFI accepted that the *Green Book* applied to the bank recapitalisation. Yet in a subsequent letter of 21 April, UKFI stated that it considered environmental factors to be in no way 'relevant' to

any of its decisions regarding the recapitalised banks. UKFI did not conduct any assessment of whether it would undermine its response to the financial crisis and its efforts to support RBS if it were to impose minimum standards for investment on RBS. But, according to the UN Principles of Responsible Investment, responsible institutional investors must take “climate change into account as part [of their] approach to fiduciary duty”.

Towards a Royal Bank of Sustainability: How could the money have been invested?

Calculations produced by **nef** for the Green New Deal Group first published in its report, *The Cuts Won't Work*, show the impact of a range of investments in a range of renewable energies, for example:

A sample of £10 billion invested in the energy efficiency sector:

- It would create 60,000 jobs (or 350,000 person-years of employment) while also reducing emissions by a further 3.96 MtCO₂e each year.
- This could also create public savings of £4.5 billion over five years in reduced benefits and increased tax intake alone

A sample of £10 billion invested in onshore wind:

- This would create over 36,000 jobs in installation and direct and indirect manufacturing. This is a total of 180,000 job-years of employment – here we have described each ‘job’ as providing stable employment for an average of five job-years. It would also create a further 4,800 jobs in the operations and maintenance of the installed capacity and other related employment over the entire 20-year lifetime of the installation (equivalent to 96,000 job-years)
- And, if this directly replaced energy from conventional sources, it could decarbonise the UK economy by 2.4 per cent – reducing emissions from the power sector by up to 16 Mt CO₂e each year This corresponds to a £19 billion reduction in environmental damage.

Box 11. A manifesto for better banking

In Spring 2008, **nef**, together with the organisation Compass published *A manifesto for better banking*. This is a summary.

British citizens will be burdened for many years with either higher taxes or cuts in public services – because of an economic crisis whose origins lay in the financial system, a crisis cooked up in trading rooms where not just a few but many people earned annual bonuses equal to a lifetime's earnings of some of those now suffering the consequences.

Adair Turner, Head of the Financial Services Authority, 2009

A focus on public spending cuts has drawn public and media attention away from the cause of the economic crisis allowing the banks to quietly slip back to business as usual. With some of our largest banks effectively in public ownership we have a once-in a lifetime opportunity to shake-up the provision of finance in the UK, making banks serve the needs of their customers and the productive economy, rather than provide short-term gains for shareholders and profits for themselves.

The manifesto sets out the basic conditions for root and branch reform of the banking sector. It includes ensuring targeted support for key sectors of the economy, such as the 'green collar' sector. It is a programme the Government must engage with if we are to develop a system that irrigates finance through the UK economy as a whole. We must not let the difficulties – complexity, global reach, virtualism – deter us. In the aftermath of the recession and in the face of new challenges like climate change, the UK is facing a great transition to a new kind of economy. Here is where it must begin:

Reform the banks

- 1. Separate retail banking and speculation.** Risky activities should be separated to insulate retail services from the volatility of international capital markets.

2. **Break up banks that are ‘too big to fail’.** Banks should be reduced to a size at which their failure would not threaten the wider economy.
3. **Complete a rigorous competition enquiry into the banks** that also examines the role played by ratings agencies and accountancy firms. The tight cartel of banks that raise funds for the government and companies in the international capital markets must also be investigated.
4. **Build better regulation.** An effective regulatory system needs to ask more questions and not accept the prevailing orthodoxy. Regulators need to ‘lean against the wind’, look ahead, take counter-cyclical action to ensure stability and be tougher on bigger banks that pose bigger threats.

Introduce new checks and balances:

5. **Introduce new controls on bonuses.** New controls must end the payment of excessive bonuses to bankers who brought the system to its knees.
6. **Introduce a UK Community Reinvestment Act** that ensures that banks lend money where they are prepared to take deposits.
7. **Introduce a Universal Banking Obligation and ensure a taxpayer ‘quid pro quo’ for future bank support.** This must cover both where banks lend and a banking code that ensures that everyone has access to essential financial services.
8. **Introduce a financial transactions (or ‘Robin Hood’) tax.** The IMF has proposed both a new levy on banks as well as a tax on profits and remuneration. But, an automatic transactions tax has broad benefits and should be implemented.

Create new institutions to underpin a better banking system:

- 9. Create a national Post Bank based on the Post Office network** to address financial exclusion and provide real, fairly-priced competition in local communities.
- 10. Capitalise a Green Investment Bank** to channel finance towards building the low carbon infrastructure we need, enable existing industry to go green and build the skills to make Britain a world leader in the field.

Box 12. Move your Money: how the backlash against finance opens opportunities for better banking

In the US, where the loss of bank diversity has not reached that of the UK,⁶⁸ an initiative launched by the influential blog, the Huffington Post, encouraged US savers to move their money out of the ‘too big to fail’ banks and into local community banks and credit unions.

The ‘Move your Money’ Campaign, launched by the blog’s founder Arianne Huffington in December 2009, estimates that two million people in the US left their big banks in the first three months of 2010 alone. Other opinion polls place this as part of a wider trend. A Zogby Interactive poll showed that nine per cent of US adults had already taken some of their money away from the big banks in protest at their behaviour. Yet another survey revealed that almost two-thirds of Americans would consider leaving their bank.⁶⁹ While Democrats are revealed as more likely to consider moving their money out of big banks, one-quarter of Republicans have also considered moving their money.

Anger at the big banks is also evident at state level: New Mexico’s house of representatives voted unanimously to pass a bill that allows the state to move \$2-5 billion of state funds to credit unions and small banks. There are signs of future institutional shifts too. American legislators are looking at the model of the 90-year-old Bank of North Dakota, owned by the state, the only one of its kind in the country, currently home to \$3.9 billion in assets.⁷⁰ In 2008, while mainstream banks lost billions, the Bank of North Dakota made record profits.

In the UK, where banking consolidation is greater, we don’t have the range of alternatives available to US savers. However, there are choices we can make from ‘deep ethical’ banks like Triodos, the Co-operative Bank, credit unions and the innovative community banking partnerships currently operating in communities around the UK. Although credit unions aren’t a common feature on the high street in the UK, they are in Ireland where 50 per cent of people belong to a credit union.

Section 8.

What should be done with banking?

*A great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money.*⁷¹

Matt Taibbi on the investment bank Goldman Sachs

To design a banking system that is fit for purpose and able to underpin the looming, great transition, we need to revisit the social and economic contract that banks have with society. To do this, we must first agree on what we want banks and financial firms to do. This can be defined as three broad functions:

1. Facilitate the exchange of goods and services.
2. Allocate capital to financially sound activities that generate the highest long-term well-being for society with the least environmental impact, and which finances the low carbon transition.
3. Redistribute and share risk.

These functions are vital to the effective operation of the economy as a whole, but they are equally vital for each individual, household, and business to fully participate in, and contribute to, the money economy. For this reason as well as for the sake of simple fairness, the banking system must be open, inclusive, and allow access to all on reasonable terms.

An increasingly concentrated, monolithic and quasi-monopolistic banking industry has spectacularly failed to deliver on its side of the social contract. What we need now is a new ecology of finance to deliver these functions: a greater diversity of institutions to serve different markets and needs, institutions that are more transparent and ethical, that are more accountable, that carry out these functions efficiently at the lowest cost commensurate with good service, and that earn a fair rate of return for their owners.

In a quite fundamental way, the analysis and conclusions of this report suggest it is time to review the current monetary system that puts the power of credit creation almost entirely in the hands of commercial banks – banks that have not only failed to look after the interests of society and the environment, but cannot even manage to look after the interests of their own shareholders.

As with natural ecosystems, diversity strengthens the resilience of the whole system. Within the system there is both fierce competition and harmonious interdependence. Diverse institutions evolve specialist attributes and abilities and the system functions more effectively in playing out a whole range of different roles.

So to evolve the ecology of finance, what needs to happen next? Many of the points below are also made elsewhere, including in **nef's** *Manifesto for better banking* (Box 11).

Out with the old

- Separate retail banking and speculation. Banks should separate out their risky activities and insulate their retail services from the volatility of international capital markets.
- Break up banks that are 'too big to fail'. Reduce banks to a size at which their failure would not threaten the wider economy.

In with the new

- Create a national Post Bank based on the existing Post Office network to address financial exclusion and provide real, fairly priced competition in local communities.
- Set up a Green Investment Bank to channel finance towards developing the low carbon infrastructure we need, enabling existing industry to go green and to build the skills to make Britain a world leader in the field.
- Encourage the expansion of existing mutual institutions and the creation of new ones, including from the nationalised banks.
- Unshackle and promote alternative financial institutions such as credit unions and community development finance institutions, and back them with an adequately resourced Big Society Bank.

Better incentives for better behaviour

- Introduce new controls on bonuses to stop the activities of banks being warped by bankers chasing short-term speculative gains at the expense of long-term value creation.
- Introduce a financial transactions (or 'Robin Hood') tax. The IMF has proposed both a new levy on banks as well as a tax on profits and remuneration. But an automatic transactions tax has broad benefits too and should be brought in.
- Introduce a 'Statement of Purpose' requirement for banks and banking activities to allow regulators and customers to assess how much the activity contributes (or doesn't contribute) to a productive economy that serves society and protects the environment.
- Introduce controls on speculation in commodities over and above that required to provide liquidity to the market, and commercially legitimate risk management. A system that allows Mayfair hedge-fund managers to get rich by causing Malawians to go hungry is morally bankrupt.

Ensuring fairness, transparency, and stability

- Demand better regulation. An effective system of regulation needs to question institutions more and not accept the prevailing orthodoxy. Regulators need to 'lean against the wind' and be counter-cyclical in nature and tougher on bigger banks who pose bigger threats.
- Launch a competition enquiry into the banks that looks also at the role played by ratings agencies and accountancy firms. A competition inquiry is needed into the tight cartel of banks that raise funds for the government and companies in the international capital markets.
- Introduce a Universal Banking Obligation and ensure a taxpayer 'quid pro quo' for future bank support. There must be a Universal Banking Obligation which covers both location and a banking code covering the principles of fair charges, and ensures that everyone has access to essential financial services.
- Introduce a UK Community Reinvestment Act which insists that banks lend money where they are prepared to take deposits.

Box 13: Public appetite for reform is ahead of government

A range of opinion polls in the UK indicate that public opinion is far ahead of government when it comes to banking reform. A Yougov poll published in February 2010 revealed the extent of public anger at City excess:⁷² 76 per cent of people said that they would support a cap on banking bonuses; 59 per cent would support windfall taxes on bankers' bonuses, and 60 per cent wanted the tax to be extended to people working in hedge funds and private equity houses.

There was also support for other forms of regulation, with most supporting a levy on financial transactions. Almost seven out of ten people also wanted retail and investment banking separated. Three out of four people said they did not think banks had changed and were still not being properly regulated.

An August 2010 poll found overwhelming public support for stricter limits on the cost of consumer credit:⁷³ 68 per cent said that they thought the government should introduce a lending rate cap to cover all forms of consumer credit, including unsecured credit. This challenges the government's plans to give regulators new powers to define and ban excessive interest rates on credit and store cards because it falls short of a commitment to cap excessive borrowing rates in the unsecured credit sector. The poll also found that seven out of ten want the government to provide support for alternative sources of affordable credit through a Post Bank, credit unions and community development finance initiatives.

Above all, the regulatory and structural reform processes currently underway should not forget to ask the question 'Will these changes lead to a financial system that better serves the people and the planet?' We deserve nothing less.

Endnotes

- 1 Cited in Ahamad (2009) *Lords of Finance*, p. 427.
- 2 Pimlott D (2010) 'Emergency budget will hit poor hardest' *The Financial Times*, 24 August 2010. Available at: <http://www.ft.com/cms/s/0/a78fde78-afc2-11df-b45b-00144feabdc0.html> [5 September 2010].
- 3 Lambe G (2010) 'Bank crisis: payback time' *The Banker*; 30 August 2010. Available at: http://www.thebanker.com/news/fullstory.php/aid/7533/Payback_time.html [5 September 2010].
- 4 Bernanke BS (2006) 'Modern Risk Management and Banking Supervision', at the Stonier Graduate School of Banking, Washington, DC. 12 June. Available at: <http://www.federalreserve.gov/newsevents/speech/Bernanke20060612a.htm> [5 September 2010].
- 5 Galbraith JK (1954) *The Great Crash 1929* (London: Penguin).
- 6 Haldane AG, Alessandri P (2009) *Banking on the State* (London: Bank of England).
- 7 Speech by Mervyn King, Bank of England Governor, to Scottish Business Organisations in Edinburgh 20 October 2009.
- 8 For more detailed descriptions of the process of credit creation see Werner R (2009) *The accounting mechanics of credit creation*. Discussion paper (Southampton: Centre for Banking finance and Sustainable Development, School of Management, University of Southampton).
- 9 For more detailed descriptions of the process of credit creation see Huber J, Robertson J (2000) *Creating new money: A monetary reform for the information age* (London: nef).
- 10 The Payments Council (2010) *The Way We Pay 2010*. The Payments Council April 2010. Available at: http://www.paymentscouncil.org.uk/files/payments_council/the_way_we_pay_2010_final.pdf [5 September 2010].
- 11 UK Payments Administration (2009) Report states that cash is still king, but for how long? Available at: http://www.ukpayments.org.uk/media_centre/press_releases/-/page/660/ [31 August 2010].
- 12 Based on Bank of England figures at 31 December 2009 for data series LPQVQKT (Notes and Coins), of £50,263 million and data series LPQAUYM (M4) of £2,043,532 million.
- 13 Federal Reserve bank of Chicago (1961) *Modern money mechanics: a workbook on deposits, currency and bank reserve* (Chicago: Federal Reserve Bank of Chicago).
- 14 Galbraith J (1975) *Money: Whence it came, where it went* (Boston: Houghton Mifflin).

- 15 Tily, G (2007) *Keynes's General Theory, the Rate of Interest and 'Keynesian Economics'* (London: Palgrave Macmillan).
- 16 'The world's most expensive cocktail launched at £35,000 a glass' *Mail* online (2007). Available at: <http://www.dailymail.co.uk/news/article-500581/Worlds-expensive-cocktail-launched-35-000-glass.html> [31 August 2010].
- 17 'In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.' P15, Chairman's Letter, Berkshire Hathaway 2002 Annual Report.
- 18 Investment Property Databank UK Quarterly Property Index 2008.
- 19 UK Commercial Property Lending Market survey by De Montfort University, reported by the British Property Federation. Available at http://www.bpf.org.uk/en/newsroom/press_release/PR3610_Payback_time_for_55bn_of_property_debt__De_Montfort_report.php [31 August 2010].
- 20 'RBS shares plunge 64% after it reveals 'reckless' lending to foreign borrowers sparked losses of £28billion', *Daily Mail*, 19 January 2009. Available at: <http://www.dailymail.co.uk/news/article-1121385/RBS-shares-plunge-64-reveals-reckless-lending-foreign-borrowers-sparked-losses-28billion.html> [31 August 2010].
- 21 'Clegg attacks Brown over RBS funding for Cadbury bid' BBC News, 21 January 2010. Available at: http://news.bbc.co.uk/1/hi/uk_politics/8470776.stm [31 August 2010].
- 22 Nissan S, Spratt S (2009) *The Ecology of Finance* (London: nef).
- 23 Holmes I, Mabey N (2010) *Accelerating the Transition to a Low Carbon Economy: The Case for a Green Infrastructure bank* (London: E3G).
- 24 UK Statistics Authority (2009) *Code of Practice for Official Statistics*. Available at: <http://www.statisticsauthority.gov.uk/assessment/code-of-practice/index.html> [4 September 2010]
- 25 IMF (2007) *Code of good practices on fiscal transparency*. Available at: <http://www.imf.org/external/np/fad/trans/code.htm> [4 September 2010].
- 26 Hobbs D (2009) *Wide measures of public sector debt* (London: Office of the Public Sector). Available at: <http://www.statistics.gov.uk/articles/nojournal/wider-measures-public-sector-debt.pdf> [4 September 2010].
- 27 'Where'd the bailout money go? Ssh, it's a secret' (2008) AP. Available at: <http://www.msnbc.msn.com/id/28344965/> [4 September 2010].
- 28 Varley J (2009) 'The role of banks and banking in society', originally published in *The Sunday Telegraph*, and reproduced in Barclay's Annual Report. Available at: <http://www.barclaysannualreport.com/ar2009/index.asp?pageid=65> [4 September 2010].
- 29 Bowers S, Finch J, Jones R, Teather D, Inman P (2009) '£37 bn bail-out will encourage reckless banks, says HBSC boss', *The Guardian*, 11 November 2008. Available at: <http://www.guardian.co.uk/business/2008/nov/11/hsbc-michael-geoghegan-banking-bailout> [4 September 2010].
- 30 <http://www.ukfi.co.uk/publications>
- 31 Joseph Schumpeter, 1954, pp. 1114–16.

- 32 Chick V (2008) 'Could the crisis at Northern Rock have been predicted?: An Evolutionary Approach', *Contributions to Political Economy*; **27**, July, 115-24. (p. 5).
- 33 Chick V (1993) 'The evolution of the banking system and the Theory of Monetary Policy', in S.F. Frowen (ed.) *Monetary Theory and Monetary Policy: New Tracks for the 1990s* (London: Macmillan) pp 79–92.
- 34 'Timeline: Northern Rock crisis', BBC News (2008). Available at: <http://news.bbc.co.uk/1/hi/business/7007076.stm> [5 September 2010].
- 35 Bank of England (2010a) *Trends in Lending* (London: Bank of England) p1. Available at: <http://www.bankofengland.co.uk/publications/other/monetary/trendsinlending.htm> [4 September 2010].
- 36 Fisher P (2009) 'The Bank of England's Balance Sheet: Monetary Policy and Liquidity Provision during the Financial Crisis', 19 November (London: Bank of England) .
- 37 Kellaway M (2009) *Public Sector Interventions in the Financial Crisis* (London: ONS). Available at: <http://www.statistics.gov.uk/ci/article.asp?ID=2301&Pos=1&ColRank=1&Rank=1>
- 38 Bank of England (2009) *Asset Purchase Facility*. Available at: <http://www.bankofengland.co.uk/publications/news/2009/009.htm> [5 September 2010].
- 39 Fisher (2009) *op. cit.* p8.
- 40 Haldane and Alessandri (2009) *op. cit.*
- 41 J.M. Keynes, June 1931, *Collected Writings*, Volume XIII, p. 363.
- 42 BBA (2010) *Small Business Support*. Available at: <http://www.bba.org.uk/statistics/article/small-business-support-june-figures> [5 September 2010].
- 43 Bank of England (2010b) *Inflation Report 2010*. Available at: <http://www.bankofengland.co.uk/publications/inflationreport/ir10feb.pdf> [5 September 2010].
- 44 BIS (2010) *Financing a Private Sector Recovery*, Department for Business, Innovation and Skills and HM Treasury. Chart 3.6. Available at: <http://www.bis.gov.uk/assets/biscore/corporate/docs/f/10-1081-financing-private-sector-recovery.pdf>
- 45 Bank of England (2010a) *op. cit.* p5.
- 46 French D (2009) *Branch Network Reduction Report 2010* (London: Campaign for Community Banking).
- 47 *Ibid.*
- 48 Coney J (2010) 'Fury over Britain's vanishing banks', *Money Mail*, 3 February 2010. Available at: http://www.thisismoney.co.uk/savings-and-banking/article.html?in_article_id=498645&in_page_id=7 [5 September 2010].
- 49 Lloyds Banking Group Plc (2010) Annual report and accounts. Available at: http://www.lloydsbankinggroup.com/investors/financial_performance/company_results.asp [5 September 2010].

- 50 RBS (2010) *Annual report and accounts 2010*, p 141. Available at: <http://annualreport2009.rbs.com/microsites/annual-report-2009/index.html> [5 September 2010].
- 51 Nationwide (2010) *Annual report 2009*, p 99. Available at: <http://www.nationwide.com/nationwide-annual-report.jsp> [5 September 2010].
- 52 Bank of England (2010b) *op. cit.* p 5.
- 53 Bank of England (2010c) *Financial Stability Report*. Section 4. Available at: <http://www.bankofengland.co.uk/publications/fsr/index.htm> [5 September 2010].
- 54 *Ibid.* Chart 4.16.
- 55 Lloyds Banking Group Plc (2010) *op. cit.* p 13.
- 56 Bank of England (2010c) *op. cit.*
- 57 *Ibid.*
- 58 BIS (2010) *op. cit.* p18.
- 59 Haldane and Alessandri (2009) *op. cit.* p2.
- 60 BIS (2010) *op. cit.* p3.
- 61 Pringle R (2009) 'Confronting the financial lobby', *Central Banking*, November 2009.
- 62 Trichet JC (2010) 'Stimulate no more – it is now time for all to tighten', *Financial Times*, 22 July. Available at: <http://www.ft.com/cms/s/0/1b3ae97e-95c6-11df-b5ad-00144feab49a.html> [5 September 2010].
- 63 Ryan J (2009) *King suggests splitting up largest banks to stem risk*. Available at: <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aADP3tUMTdVE> [5 September 2010].
- 64 Benjamin A (2007) 'Stern: Climate change a market failure', *The Guardian*. Available at: <http://www.guardian.co.uk/environment/2007/nov/29/climatechange.carbonemissions> [5 September 2010].
- 65 Clark A, Treanor J (2008) 'I was wrong about the economy. Sort of.', *The Guardian*. Available at: <http://www.guardian.co.uk/business/2008/oct/24/economics-creditrunch-federal-reserve-greenspan> [5 September 2010].
- 66 *Ibid.*
- 67 The World Development Movement, PLATFORM, and People & Planet.
- 68 Half of all money, 47 per cent, is already deposited with local banks.
- 69 The Survey of 2068 US adults was conducted from Feb 17–19 2010. The survey asked all respondents if they had "considered moving some or all of (their) banking from a large national bank to a community bank or credit union because (they) are unhappy with the policies or behaviour of large national banks". Nearly one in three (32%) answered yes.

- 70 Harkinson J (2009) 'How the nation's only state-owned bank became the envy of Wall Street', *Mother Jones*. Available at: <http://motherjones.com/mojo/2009/03/how-nation%e2%80%99s-only-state-owned-bank-became-envy-wall-street>
- 71 Taibbi M (2010) 'The great American bubble machine' *Rolling Stone* 1082-1083 from July 9–23, 2009. Available at: http://www.rollingstone.com/politics/news/12697/64796?RS_show_page=0 [5 September 2010].
- 72 Anushka Athansa (2010) 'New poll reveals depth of outrage at bankers' bonuses', *The Observer*, 21 February. Available at: <http://www.guardian.co.uk/business/2010/feb/21/bank-bonuses-outrage-opinion-poll>
- 73 '7 in 10 demand lending rate cap to cover all forms of credit', *Compass*, Sunday 22 August 2010. Available at: <http://www.compassonline.org.uk/news/item.asp?n=10517>



The Great Transition

The UK like many nations is in the midst of a triple crunch – a coming together of credit-fuelled financial crisis, accelerating climate change and highly volatile energy prices underpinned by the approaching peak in global oil production. These are no longer abstract, distant issues of financial and environmental policy. They are beginning to affect everyone. The Great Transition shows why we need to get behind solutions that can proactively deal with climate change, the economic crisis and are also socially progressive. These are choices we must take, because ahead, both progressive and poisonous political trains of thought may emerge.

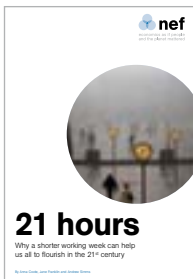
The Great Transition sets out why the transition to a new economy is not only necessary, it is both possible and desirable.



The ecology of finance

The UK's financial sector has made itself rich at the expense of an increasingly fragile economy. In the aftermath of the recession and in the face of challenges like climate change, the UK is facing a great transition to a new kind of economy. Only radical reform of the UK banking and financial sector can deliver institutions capable of economically and socially productive investment and lending. *The Ecology of Finance* shows how radically recasting the banking and financial sector could meet the proper function of finance. Freed from short-term and profit-driven models of lending and from risky, volatile speculative investment, the

banking sector would, instead, form a highly diverse 'ecology' of institutions that range in structure, market sector and scale; fit for the complexity and shared long-term goals of the economy.



21 Hours: Why a shorter working week can help us all flourish in the 21st century.

21 Hours shows how reducing the amount of time devoted to paid work opens up a huge range of possibilities for richer and more fulfilling ways of organizing our lives. It documents the forces pushing us towards a shorter working week: economic failure revealed by the banking crisis, an increasingly divided society where over-work is matched by unemployment, and an urgent need for deep cuts in environmentally damaging over-consumption. And, there is a growing interest in people

spending more time producing and delivering a share of their own goods and services – from co-produced care and neighbourhood-based activities, to food, clothing and other necessities.



THE GREAT TRANSITION

Necessary Desirable Possible

Finding ways to survive and thrive through financial and climate crises and the peak and decline of global oil production.

To find out more and become part of it visit: www.neweconomics.org

Written by: Andrew Simms and Tony Greenham

Additional material was provided by: Deborah Hargreaves, Ruth Potts, Richard Murphy, Lindsay Mackie, and friends of the Great Transition.

With thanks to: The Network for Social Change, PLATFORM and the convenors of the Policy and Research Institute for Macroeconomics (PRIME) network for their help with the development and preparation of this document.

Edited by: Mary Murphy – www.irjjo.com

Design by: the Argument by Design – www.tabd.co.uk

Cover image by: R Jay GaBany in collaboration with David Martinez-Delgado www.cosmotography.com

new economics foundation

3 Jonathan Street
London SE11 5NH
United Kingdom

Telephone: +44 (0)20 7820 6300

Facsimile: +44 (0)20 7820 6301

E-mail: info@neweconomics.org

Website: www.neweconomics.org

Registered charity number 1055254

© October 2010 **nef** (the new economics foundation)

ISBN 978 1 904882 82 7