POST-BREXIT ANALYSIS

Reforming the banks – the opportunity of Brexit

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Brexit offers an unexpected opportunity: to use the taxpayer's stake in RBS to begin to transform our banking sector into a locally-based, locally-focused system that works for small and medium-sized businesses in the real economy.

The campaign for Britain to leave the European Union promised to let people 'take back control'. Hardly anyone now disputes that the resonance of this sentiment was about much more than Brussels bureaucrats, or even – despite the terrifying lurch towards xenophobia we have witnessed since the referendum – immigration. In recent decades we have built an economy and a politics that has left large swathes of the country behind and millions of voters feeling powerless.

If we want to understand how this has happened and how we might begin to put it right, our banking system is not a bad place to start. After all, since the crisis of 2007-08, big banks have come to exemplify the feeling that our lives are controlled by an unaccountable elite, and that we are powerless to do much about it. But it goes deeper than that: the political decision to build an economy specialised in financial services has allowed the City of London to flourish at the direct expense of many of the communities that voted Leave.

Moreover, with the pound plummeting and signs pointing towards a 'hard Brexit', it looks increasingly likely that Brexiteers may have blown up the very economic model they claimed to be defending. Our economic settlement is in genuine flux – but what comes next could well be even worse. It is crucial that progressives seek to understand the political choices that lie ahead in the coming months and years, and begin to build the solutions, the alliances and the new economic consensus that could really give people control.

How did we get here?

There can hardly be a better illustration of who's really in control of our economy and our politics, and of how we've lost control, than the banking sector. The 'Big Bang' deregulation of the 1980s did not bring greater competition and dynamism, but the exact opposite: the UK's local banks and building societies were almost all destroyed and swallowed up by conglomerates, until we were left with a top-heavy system dominated by four shareholder-owned banks so huge they could not be allowed to fail.

This matters because banks themselves control the lifeblood of our economy: the money supply. Banks don't just take in customer deposits and lend them out, as is commonly assumed. Rather, when a bank makes a loan, it *creates* a corresponding new deposit – in other words, new money – out of thin air, simply by typing numbers into a computer system.[1] This means that the shape of our banking system determines where money goes – and where it doesn't.

Our banking system is now one of the most centralised and least diverse in the developed world. Shareholder-owned banks control nearly ninety per cent of the market, compared to less than half in Germany, France, and Spain. Less than five per cent of the market is controlled by regional and local banks, compared to around two-thirds in Germany, half in Spain and a third in the United States.[2] This makes us extremely vulnerable to financial crises, since we are highly dependent on a small number of very big banks that all look and act in similar ways, and are therefore likely to experience problems at the same time.

And our system is not just a monoculture: it's a monoculture of a peculiarly dangerous type. Over the last thirty years, the business models of large, global commercial banks have shifted radically, from mainly investing in the 'real economy' – for example through business lending – to mainly pumping up the price of assets in the 'financial economy' – for example through mortgage lending and lending to other banks and financial institutions. This process has been turbo-charged by securitisation: the practice of packaging loans up and selling them on, which proved so toxic during the financial crisis.

All this is no accident. The 'Big Bang' reflected a political choice to focus on the UK's 'comparative advantage' in financial services – to nurture finance as the thing we sell to the rest of the world, as a sector in its own right creating jobs and profits, rather than as a means of channelling investment into productive activities. In other words, finance was to become not the oil in the engine, but the petrol fuelling it.

But, as the Brexit vote has made painfully clear, this came at the expense of the system's core function. Highly centralised City banks could make much easier profits trading on international markets and providing high-value investment banking services than by the slow, difficult business of building relationships with small businesses up and down the country. This is one of the reasons we are now the most regionally unequal country in Europe.

Only London and the Southeast have a higher income per head than the EU-15 average,[3] with all other regions – representing seventy-three per cent of the population – less wealthy than the average. The gradual abandonment of communities and retreat from the high street is now accelerating again as online banking makes branch networks less profitable. More than 600 branches closed in 2015,[4] with rural communities especially badly hit, and many left with no bank at all. Research by Move Your Money found a measurable decline in small business lending in affected communities.[5] Small businesses also suffer indirectly when nearby branches close, as people are more likely to go elsewhere to shop and bank at the same time.

But the choice to specialise in financial services and rely on the City of London has not just neglected other regions and sectors – it has actively undermined them. London's status as a global financial hub, and the tsunami of capital in-flows from abroad that goes with it, has kept the pound high, making our exports more expensive. This has accelerated deindustrialisation in former manufacturing areas and produced a yawning trade deficit.

Both directly and indirectly, then, our broken banking system is sapping control away from communities – particularly the former industrial areas, rural and coastal communities who voted Leave. The Brexit vote exposed these fault lines badly: as banks pump money into London housing and international markets, leaving the rest of the country behind, we've created an economy so skewed that it is reaching breaking point.

It should now be obvious that we can't build an economy where everyone can prosper by relying solely on a small number of high value jobs in the City. Nor is it enough to simply outsource some of these jobs to cities like Manchester under the banner of the 'Northern Powerhouse'. If we want an economy that gives people real control, our banking system itself needs to change.

What would it mean to really take control?

This does not just mean regulating our existing banks more heavily, or putting more pressure on consumers to switch in the hope of reviving competition (the approach recently taken by the Competition and Markets Authority).[6] Instead, we need structural change to the banking landscape. We need to learn from other countries about the kind of banking ecosystem that can support communities and build a resilient economy. We need to create new kinds of bank that do their job of serving the rest of the economy, not just acting as a sector in their own right.

'Stakeholder banks': learning from overseas

We badly need to democratise our banking sector – with diverse forms of public, mutual and co-operative ownership which give more collective control to customers, frontline workers and local communities, and which are mandated to focus their lending on supporting these communities, not on unproductive speculation. Collectively, we call these solutions 'stakeholder banks': this includes public savings banks, building societies, co-operatives, credit unions and community development finance institutions (CDFIs).

The UK is highly unusual in having virtually none of these banks in the mix. International evidence shows that they lend more to the real economy, serve customers better, keep more branches open and create more jobs – as well as being safer, less volatile and less likely to fail.[7] In Germany and Switzerland, local stakeholder banks kept the economy going through the recession after 2008, continuing to increase their lending while big banks were withdrawing it.[8]

This may be because they are restricted to more socially useful retail activities, and cannot engage in the kinds of activity which now dominate our banks' business models; because they are accountable to communities rather than simply to maximising shareholder returns; or because they are locally-focussed, allowing them to build real relationships with borrowers that can survive an economic downturn. Most likely it is a combination of all three. Because they spread control more widely, they are also safer for the system as a whole – because risk is less concentrated in a small number of very large, very significant banks.

In order to better understand the contrast between our banking system and that of many other developed economies, it is worth looking at the German example in a little more detail. The German banking system is much more diverse and localised than ours, underpinned by an ecosystem of public banks at three levels:

> The Sparkassen are a network of public savings banks, owned in trust for the public benefit, accountable to local communities and run with representation from local people, with a mandate to lend and provide banking services in their local areas.
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> The Landesbanken are regional banks which give the Sparkassen access to some investment and wholesale banking services. While the Sparkassen themselves proved very resilient during the financial crisis, the Landesbanken ran into problems, mainly as a result of coming under pressure to imitate commercial banks by investing in riskier assets.
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> The KfW is a national state investment bank which invests in strategically important sectors (like renewable energy) via the Sparkassen. In this way the German system combines state support with localised lending and decision-making embedded in communities.

The German system performs much better than the UK on a whole host of measures, including lending to the real economy, balance between different geographical areas, keeping branches open and creating local jobs, as well as resilience to crisis.

Of course, it is not without its problems, as the recent travails of Deutsche Bank illustrate. But the case of Deutsche Bank only makes the contrast between the UK and the German systems even starker. In the 1980s, it made a deliberate decision to become a global investment bank rather than serving the German domestic economy. But while Germany protected the status of its local public banks, the UK sabotaged our mutuals. This means that our economy depends on the likes of Barclays and RBS in a way that the German economy simply does not depend on Deutsche Bank.

Transforming the landscape: reforming RBS

Achieving this kind of transformation in our banking system is, of course, much easier said than done. Ultimately, it requires a fundamental break with the current regulatory approach, with much greater willingness both to challenge the business models of incumbent banks and to intervene to support new ones. This could involve breaking up big banks through real separation of retail and investment banking, or rewriting regulations (for instance, on how much capital banks have to hold) so that they support smaller stakeholder banks rather than being shaped around the interests of big international players.

To say the least, the chances of this happening currently seem slim. And rebuilding a strong stakeholder banking sector from the ground up would certainly take decades. But there is one policy that, if fought for successfully, could transform the landscape at a stroke.

We already own one of the UK's biggest banks – RBS, which was bailed out to the tune of £45.5bn and is still seventy-three per cent owned by the taxpayer.[9] We could use our stake in RBS as a golden opportunity to start taking control of our banks – building a system that really puts people and communities in the driving seat.

So far, the government has refused to consider any options for RBS's future other than handing control back to the financial markets. Indeed, the terms of the bail-out meant that we never really took control of RBS in the first place, with the government holding its shares through an arms-length body (UK Financial Investments) and no conditions being imposed in return for the state support that rescued the bank.

This means that, although RBS's strategy has shifted significantly since the crisis, its incentives as a large shareholder-owned bank have stayed essentially the same – and it remains one of the worst offenders both in terms of its treatment of small businesses (particularly via the notorious Global Restructuring Group, which leaked documents now show deliberately stripped the assets of struggling businesses to bolster RBS' own balance sheet),[10] and in terms of its treatment of rural communities, where it is closing branches faster than any other bank.

But RBS now can't be sold back to the private sector in the foreseeable future. In the wake of the Brexit vote, like many other banks, its share price crashed to the point where selling now would lose the taxpayer an eye-watering £30bn – nearly two-thirds of the amount we paid to bail it out in the first place.[11] Prior to the 2015 election, George Osborne had publicly indicated that he wanted to see the taxpayer break even on the sale of RBS.[12] Although this ambition seems to have been abandoned, a £30bn loss is clearly unacceptable, and creates a window of opportunity to insist that other options be put back on the table.

NEF has proposed turning RBS into a network of 130 local stakeholder banks, modelled on the German Sparkassen – run with representation from workers, customers and the local community, and with a mandate to serve their local area.[13] The first step to do this would be for the government to buy up the remaining shares – at historically low prices – and shed the investment and private banking arms, using the bank's high-street operations as the basis for the new network.

This model could turn RBS from the poster-child for everything that is wrong with our banks into a beacon of what could be possible. Instead of a bank that exploits small businesses, we could create a network of banks that is directly accountable to them, with a mandate to support them. Instead of a bank that is abandoning rural communities, we could create a network of banks rooted in those communities, investing in regions that have been left behind and helping them take control of their economic futures.

Where next? The banks after Brexit

In the wake of Brexit, we face a stark choice. Do we double down on our broken economic model, further cutting taxes and regulation for the City in an effort to maintain our status as a global financial centre? Or do we recognise that we can't build our national prosperity on a few high-value jobs in the Square Mile, genuinely rebalance our economy and reshape our banking system?

At the moment, the outlook does not look promising. In the weeks immediately after Brexit, many politicians and commentators appeared preoccupied with persuading banks not to move their headquarters to Paris or Frankfurt. Banks themselves focussed on issues like 'passporting' into the single market and lobbied actively for a soft Brexit on favourable terms for the City.[14] More recently, talk of a 'hard Brexit' has been interpreted in some quarters as a sign that the political winds are changing, and that control over immigration now trumps special treatment for banks.

But of course, 'hard Brexit' is equally far removed from the change in course we need. Rather than transforming our economic model, it risks putting it on steroids. It is already being hinted that to survive outside the single market, the UK will need to further cut tax and regulation in what is already among the most deregulated economies in the developed world – in other words, to turn ourselves into a tax haven. Indeed, escaping the 'burden' of EU laws and regulations and being free to negotiate new, more liberalised trade deals is one of the key attractions of 'hard Brexit' for many of its advocates.

Meanwhile, if UK banks do lose access to the single market, competition to attract their headquarters could trigger a new international 'race to the bottom' on tax and regulation. There are already some early signs of this, such as Germany reforming its labour laws to attract firms to Frankfurt.[15]

Faced with a Hobson's choice between defending a broken status quo and allowing the 'tax haven Britain' route to proceed unchallenged, how should progressives respond? For one thing, we urgently need fresh thinking about what a truly progressive economic relationship with the rest of the world might look like – one more focussed on making the banks safe for our economy than on making the economy safe for our banks. New polling for NEF shows that seventy-seven per cent of Remain voters believe international co-operation is needed to tackle issues like tax avoidance and climate change.[16] Financial stability needs to be added to that list – and we need to find ways to mobilise around the benefits of international law, rather than allowing the agenda to be set by those who consider it merely a burden.

But in the meantime, the groundwork for building a better banking system also has to start at home. It's nearly ten years since the financial crisis, and little seems to have changed. The circumstances might seem bleaker than ever, but with so much uncertainty in our politics and our economic life, there has never been a more important time to begin laying the foundations for real change. Here are three suggestions for steps we can begin taking right now:

1. *Advocate reform of RBS*. As Theresa May's government begins to adopt the rhetoric of economic transformation, bold proposals are needed to show what true transformation might look like. Turning RBS into a network of local banks, able to genuinely serve the left-behind communities that voted to Leave, could be such a proposal. If nothing else, it opens up a debate about the kind of banking system we really want. And with the bank unsellable for the foreseeable future, calls to re-examine other options – if made loudly enough – become harder to credibly resist.

2. *Build new local and community banks*. Evidence from abroad shows that co-operating in networks is important to the success of local stakeholder banks. But, while that means systemic interventions are needed, it shouldn't stop us from prototyping new and better banking solutions at the local level. For example, the Community Savings Bank Association is working with local authorities and others in an attempt to rebuild a network of co-operative regional banks from the ground up.[17] Working with Airdrie Savings Bank, it hopes to simplify the process of starting a new bank by taking care of many of the practical and regulatory hurdles that hold back new banks.

3. *Organise small businesses and rural communities*. There are plenty of potentially powerful groups that have reason to want to take control of our banking system – from small businesses fighting for redress after being mis-sold products that bankrupted them, to rural communities losing the last bank in town. If we can find more effective ways to organise on the ground with these groups, and to support them in building their political power, perhaps we can build a movement

ready to seize on the next window of opportunity – and genuinely transform our banking system.

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Notes

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17 See http://www.csba.co.uk/.