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Markets for the Many:

How civic finance can open up markets and widen access

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ResPublica
changing the terms of debate

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About ResPublica

The ResPublica Trust (which operates under the trading name ResPublica) is an independent, non-partisan think tank. We focus on developing practical solutions to enduring socio-economic and cultural problems in the UK. Our ideas are founded on the principles of a post-liberal vision of the future which moves beyond the traditional political dichotomies of left and right, and which prioritise the need to recover the language and practice of the common good.

Based on the premise that human relationships should once more be positioned as the centre and meaning of an associative society, we aim to foster a 'one nation' approach to social and economic inequality so that the benefits of capital, trade and entrepreneurship are open to all. A vibrant democracy and market economy require a stronger focus on virtue, vocation and ethos. Consequently our practical recommendations for policy implementation seek to strengthen the links between individuals, institutions and communities that create both human and social capital, in order to achieve a political space that is neither dominated by the state nor the market alone.

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Foreword

by Cathy Jamieson MP, Shadow Financial Secretary to the Treasury

This Parliament has arguably been the most significant in recent times for its impact on financial reform. The Financial Services Act 2012 and the recent Financial Services (Banking Reform) Act 2013 both set out the Coalition Government's programme of financial reform and attempt to safeguard the economy against future shocks.

While the Government's reforms are a step in the right direction, they do not go far enough in creating the financial services that support our small businesses and truly serve the needs of our citizens and communities.

As ResPublica argues in *Markets for the Many*, this must be the primary and civic duty of the financial sector. In order to fulfil this, we need financial institutions capable of meeting society's demands to play a greater role in our financial sector. Building societies, mutual societies and community finance institutions, because of their growth prospects and inclusive models, have the ability to make the financial sector inherently more secure, capable and responsive.

One of the most striking realities to surface from the financial crash was how little choice and diversity exists in our financial sector. Thanks in large part to the demutualisation of the late 80s and early 90s, we have been left with a highly concentrated market dominated by a small number of large companies of the plc shareholder model. The lack of diversity in ownership models is telling when compared to our European competitors, where mutual and co-operative models enjoy a strong presence in both banking and insurance services. Whereas our citizens once enjoyed a bustling mutual and co-operative financial sector, existing alongside the plc model, their presence today is amongst the lowest in Europe.

It is also telling that since 2008, and with little help from the Funding for Lending scheme, many of our small and medium enterprises have struggled to secure finance from the large banks. These enterprises are the backbone of our economy, and ensuring they have sufficient finance options is essential to our economic recovery and future prosperity. In contrast to the established financial intuitions, building societies, who play a leading role in personal finance and mortgage markets, have seen lending levels increase.

Provision of finance has been severely limited, in some parts of society, leaving large numbers of people and communities underserved by our current system. Ensuring these communities receive bespoke financial options should be a priority.

Levelling the playing field for building societies, mutual insurers and community finance institutions to provide personal, business and community finance services alongside the established financial institutions can only be a positive step. That is why I back ResPublica's call to support the growth of these civic finance institutions.

In creating the financial sector Britain needs, adopting such an approach should be fundamental to the next wave of financial reforms.

Foreword

by Jonathan Evans MP

Parliament has passed a substantial amount of legislation affecting the financial services sector since 2010 but this has almost without exception been focused on fixing the problems of the immediate past. In particular, it has been about improving regulation and making the major financial institutions – by which we mean the big banks – more resilient to the sort of severe shocks the global financial system experienced in 2008.

So far, we have done little to address the more fundamental flaws in our financial system: customer detachment and disillusion, lack of diversity and choice, limited competition and poor support for the SME sector. These are not new problems. Indeed, they have been with us for many years but now is an ideal opportunity to address them afresh and this ResPublica report sets out an ambitious, constructive and timely agenda for doing just that.

Promoting greater diversity of ownership has to be a priority because we have a series of opportunities coming up to expand the customer-owned mutual model as the state-owned banks are returned to the private sector. An expansion of the mutual sector, accompanied by the sort of modernisation measures advocated in this report, will, I believe re-invigorate the whole market. The bond between the institution and its customers that is the hallmark of a well-run mutual will influence the established players in the market much as it did before the wave of demutualisations in the banking and insurance sectors from the late 1980s.

The key challenge is to create a financial services sector that is much more closely aligned with the needs of communities, business and society. This is vividly illustrated by the emergence of irresponsible payday loan companies. These are addressing a need seen by many people as so urgent that they will pay high interest rates and risk greater debt by dealing with these lenders. We urgently need to encourage credit unions and other community-based finance initiatives to step forward to provide an ethical, affordable and viable alternative to irresponsible lending.

In encouraging mutual and community ownership, however, we mustn't be blind to some of the shortcomings we have seen in the sector. Many of these, I believe, have come about because the current legislation forces them to behave like everybody else, especially when it comes to the huge challenges of raising finance to expand and develop. We have to create a legislative and regulatory environment that plays to the strengths of mutuality while ensuring they are managed and take the same care over their business process, security and reporting as proprietary institutions. It is not a question of lower standards but, as this report argues, more appropriate regulation.

Executive Summary

" This Civic Approach to financial reform, as we term it, looks beyond simple financial stability and prudential issues and assesses the overall ability of the sector to serve customers, help communities and support small businesses. "

The 2008 financial crisis and the ensuing economic recession irrevocably changed the UK financial sector. In the wake of the worst economic downturn in modern times, the Coalition Government made reform of the financial sector a key part of its programme for government. A wave of legislation, including the recently passed Banking Reform Act, has attempted to rectify the mistakes of the past to guard against the possibility that any future crises do not affect the UK in quite the same way.

But current attempts at reform, whilst at least welcome, are far too insular in nature, in that they focus almost entirely on prudential issues and the capabilities of individual financial institutions to withstand shocks. We argue, instead, that reform should be more outward looking and geared towards ensuring that the wider needs of society are adequately served by the financial sector. A more holistic approach to regulation and banking reform is needed in order to satisfy a wider set of public policy objectives.

This Civic Approach to financial reform, as we term it, looks beyond simple financial stability and prudential issues and assesses the overall ability of the sector to serve customers, help communities and support small businesses. We believe that the financial sector is one of society's great economic and social enablers, and has the capacity to be a truly transformative force in society. Unfortunately, the current reform agenda, with its almost exclusive emphasis on simple financial stability, fails to recognise this: it is too myopic.

We would argue that, to perform its societal role and adopt its civic responsibilities, the financial sector must, as a pre-requisite, be more competitive, diverse and responsive to customer needs. Given that market power is concentrated in a small number of organisations of one ownership type (plc bank), and that consumer trust and confidence is at an all-time low, it is clear that the financial sector is not currently in a position to perform the transformative role that the economy and wider society sorely needs.

The Government can swiftly address these inadequacies by promoting civic finance institutions, those institutions which already assume their civic role within society. This would, as a whole, make the sector more capable of meeting society's demands. This paper will primarily focus on three such elements: building societies, mutual societies and community finance institutions. We have chosen these institutions for their ability to make, due to their growth prospects and inclusive models, the financial sector inherently more secure, capable and responsive.

The ten recommendations detailed below are examples of what could be done to promote these elements and create a financial sector more able to assume its civic duty:

1. Broaden the scope of financial reform: We believe the current approach to financial reform is too focused on individual financial institutions and should focus on the wider needs of society for finance. We recommend that the Government undertake a review of its current reform policy to establish how to promote the financial sector's wider societal role as an enabler of economic prosperity.

Recommendations for building societies

2. Level the playing field for building societies: The reforms contained within the Banking Reform Act are mostly targeted at plc banks. To address this lack of concern for other types of institutions like building societies, we believe HM Treasury should establish a 'trigger' policy for future reforms. Under this, any reforms to bank policy would automatically trigger a review of building societies policy to determine if the proposed changes would have negative consequences for the sector, as well as what actions would need to be taken in order to mitigate these negative effects and level the playing field.

3. Encourage building societies to lend more to SMEs: Building societies play a leading role in the personal finance and mortgage market, but are largely absent from the corporate finance market. Loosening the limits under which building societies operate would permit them to drastically increase their lending to SMEs – something they are currently disincentivised from doing. Such a move from Government would in-turn encourage building societies to strengthen their corporate lending skills base and adopt a position within the corporate finance market similar to what they hold in the personal finance and mortgage markets, and similar to what mutual banks hold in European markets.

4. Allow building societies to take over high street banks: Building societies can demutualise and be acquired by plc banks, but building societies are prohibited from doing the same in return. This is an indication of an unfair and uncompetitive market. Allowing building societies to take over high street banks, or parts of these banks, would increase banking competition and provide greater choice to consumers. The floatation of TSB Bank in the summer of 2014 could present such an opportunity. As part of this, the Government should also consider revising the legislation concerning re-mutualisation to streamline the process by which non-mutuals convert to mutual-status. This would have significant advantages with regards attempts to increase banking competition.

Recommendations for mutual societies

5. Release additional capital for mutual societies: Mutual societies are handicapped by legislation when it comes to raising additional capital for product and service expansion. In light of this, we recommend that the

Government support the Mutuals' Redeemable Shares Bill. Supporting this important piece of legislation would level the playing field in relation to non-mutual insurers and would make it much easier for mutual societies to expand the services they offer.

6. Help establish networks of mutual societies: By establishing network organisations, mutual societies in Europe and the US are able to compete more easily with non-mutual insurers due to greater economies of scale. We recommend that HM Treasury create an expansion project, very similar to the Credit Union Expansion Project, which enables mutual societies to forge these deep networks in the UK and compete much more freely with non-mutual insurers.

7. Promote mutual societies to reduce financial exclusion: Mutual societies already offer financial products to assist those on lower-incomes, but are restrained from expanding further in this market by over-burdensome advice guidelines. We recommend that the FCA, in its role as consumer champion, immediately commence a review of the guidelines detailing 'simplified advice' to determine how a more accurate definition could encourage greater levels of financial advice to those on lower incomes.

Recommendations for community finance institutions

8. Reform the community finance market: Community Development Finance Institutions (CDFIs) often lack social finance provided by private individuals and investors. To rectify this, we recommend that all three main political parties commit to introducing a Community Reinvestment Act in the next parliament to streamline the social investment process and increase finance available to CDFIs.

9. Support the development of community finance partnerships: There does not yet exist the means by which CDFIs, credit unions and other community organisations can form long term partnerships. We recommend that the budget of the Credit Unions Expansion Project be expanded from £38m to the originally envisaged £73m. These additional funds should in turn by set aside for partnership building amongst community organisations to ensure more comprehensive community finance support.

10. Establish CDFIs as lenders of first resort for SMEs: Under Community Investment Tax Relief (CITR) rules, CDFIs can only offer finance to SMEs if they have first been refused finance by a mainstream provider. As this reduces the ability for SMEs to access finance, we recommend that this requirement of CITR be removed so that SMEs have a much easier path to debt finance.

By adopting these recommendations and shifting the focus of financial reform from the financial capabilities of individual institutions to the greater needs of our businesses and communities, we believe that the financial sector can once again be considered fit for purpose.

1. Introduction

The financial crisis that began in 2008 and the resulting world-wide recession had enormous consequences for the financial sector and the wider economy. As a result of the perceived causes of the crisis, public mood towards the sector can at best be described as hostile, and the general consensus amongst commentators is that our current model of finance is both unsustainable and unfit for purpose.

As we emerged from the crisis and the UK's longest and deepest recession, the Coalition Government pledged to reform the financial services sector to ensure that any future crises will never again affect society to the same extent. The Independent Commission on Banking (ICB) was established shortly after the 2010 General Election to assess the need for structural and competitive reform in the banking sector. The findings of the Commission's final report,[1] later incorporated in a HM Treasury White Paper,[2] recommended a package of reforms that consisted of ring-fencing legislation; measures for increased bank loss-absorbency; and proposals that would encourage greater levels of competition within the sector.[3] Many of these recommendations have now been implemented through the recently enacted Financial Services (Banking Reform) Act.

The reforms contained in the Banking Reform Act are, in the round, to be welcomed. The changes to legislation and regulation will undoubtedly make the banking sector more secure and resilient against future crises. However, despite a step in the right direction, these reforms focus too much on the prudential capability and corporate structures of individual financial institutions. Current reforms take little note of the financial sector's wider role as society's great economic and social enabler. Indeed, given their capacity to facilitate economic growth and foster community empowerment, financial institutions are, potentially at least, amongst our most transformative institutions. The central purpose of the financial sector must, therefore, be to service the needs of its customers, their communities and wider society. In doing so, the sector can lay the groundwork for a future of shared growth and widely distributed prosperity.

This report argues that, in reforming the financial sector, the Government must look beyond the prudential and individual capabilities of single financial institutions and must adopt a more holistic approach to reform that assesses the ability of the financial sector as a whole to cater for the needs of society. This holistic approach to financial reform we can call the Civic Approach, as it would require the financial sector to look beyond its own short-sighted needs and look instead towards the long term demands of society. In short, under the argued for approach, the sector would need to embrace its civic duty.

As part of this Civic Approach, it would be necessary to take a much broader view of the financial sector. The current reforms focus primarily on plc banks and not enough on other market players, such as building societies, insurers, social finance firms and innovative technology platforms such as those utilised by peer-to-peer lenders and crowdfunders. Instead of focusing primarily on those market players that have failed, a Civic Approach to financial reform would adopt a much broader view that promotes those market actors that we need to succeed. Above all, it would recognise the undoubted systemic and social benefits to be derived from considerably more diversity in ownership structures and business models of financial firms. For instance, effective competition is more likely to be enhanced through introducing greater diversity than simply by adding more homogeneous firms.

Essential to this would be analysing and assessing the healthiness and suitability of the financial sector in its entirety. This entails looking beyond individual institutions and instead focusing on the essential pre-requisites of a well-functioning financial sector in respect of what society as a whole requires from the sector. It is commonly agreed amongst regulators, economists and sector leaders that the essential requirements for a well-functioning financial sector (or indeed any sector) are that it must be suitably competitive, adequately diverse and sufficiently responsive to customer needs. Only when these requirements are met can the financial sector be said to be fit for purpose.

Thus, a financial sector with a significant number of players in each service area (lending, insurance, savings etc); a good and diverse mix of ownership models (mutuals, non-mutuals etc); and a good understanding of its customers' wants and needs, can be considered a healthy, well-functioning sector capable of meeting the UK's economic and social demands.

The fact that the UK's current financial sector is typified and dominated by a small number of firms, each of one ownership type (plc bank), coupled with a lack of consumer trust and confidence in the sector due to numerous scandals, indicates that the financial sector is not currently fit for purpose.

The current suite of reforms, whilst an important first step, will do little to increase effective competition across the financial sector, nor will they do much to promote a diversity of ownership models across banking, insurance and savings. Further, it is unlikely that the Banking Reform Act and similar items of legislation will sufficiently bridge the 'trust gap' that has developed between the sector and the general public, which is mostly the result of concerns over the causes of the crash, disproportionate banker remuneration, as well as the PPI mis-selling and LIBOR scandals.

To allay these concerns, a civic-based approach to financial reform must look to heal this rift by prioritising competition, diversity and consumer confidence in the sector alongside measures

that monitor the prudential capabilities of financial institutions. The Government can do this by promoting and encouraging civic finance institutions, those responsive and inclusive elements of the financial sector that already perform their civic role within society. These institutions would, if suitably incentivised, help to make the financial sector more balanced and capable of meeting society's demands.

The purpose of this paper is to focus on three such elements: building societies, mutual and friendly societies, and community finance institutions. These particular institutions have been chosen because of their ability to make, due to their potential growth prospects and business models, the financial sector inherently more secure and responsive.

This is not to say that other elements of the financial sector should not be promoted, or that plc banks and insurers are incapable of performing a transformative role within society, but it is to say that these three key industries have, if suitably encouraged, the potential to transform the whole financial sector for the better. The remainder of this report will outline how the Government could bring about such change.

2. Promoting Building Societies

"The first societies were established during the Industrial Revolution as mutual self-help organisations that enabled their members to pool their resources for the purposes of purchasing land and building property."

Building societies are mutual lenders and deposit takers. As such, they are owned by their customers, who they refer to as 'members'. The first societies were established during the Industrial Revolution as mutual self-help organisations that enabled their members to pool their resources for the purposes of purchasing land and building property. The first record of a community establishing a building society was in Birmingham in 1775.

The mid-18th Century witnessed a boom in building society membership as societies were permitted, for the first time through legislation, to accept savings from those not interested in purchasing property. In 1860, there were over 2,000 building societies in operation in England.[4] From then, a number of Acts were passed that modernised and expanded the operations of building societies to make them more relevant to increasingly burgeoning consumer credit, mortgage and savings markets.

The modernisation process culminated in the Building Societies Act 1986, which – whilst it consolidated existing legislation into a more accessible and coherent form – made it possible for building societies to relinquish their mutual status through the process of demutualisation. This heralded an exodus from the sector, with many building societies choosing to convert to plc banks because they considered the building society model was an impediment to their growth. There was also the accompanying factor of the windfall dividends many members would receive if they agreed to the proposal for demutualisation. The first building society to demutualise was Abbey National in 1989. Other large building societies also followed suit, including Halifax, Alliance and Leicester and the Woolwich.

At their height in popularity, building societies accounted for nearly 60 per cent of the mortgage market, but have since seen their market share decrease to around 20 per cent.[5]

In 1910 there were 1,723 building societies, many of which had their historical origins deep in the nineteenth century.[6] By 1992 the number had been reduced to 89 and further to 55 by the end of 2008 through a process of mergers and conversions to plc bank status via the demutualisation legislation.

A total of ten building societies (including eight of the largest ten that existed in 1992) subsequently converted (or in some other way abandoned their mutual status) and these accounted for 70 per cent of the total assets of building societies in 1992.[7] It is worth noting that, of those building societies that demutualised, none are still operating as an independent entity, having all merged or been since acquired.[8] Contrary to the claims made at the time, therefore, such demutualisations have not had an enduring beneficial impact on competition. Indeed, a lot has been lost through the erosion of the mutual sector.

As of 2014, in the UK there are currently 45 building societies with 21 million members. Total mortgage assets amount to £225bn, savings balances to £225bn and total assets of £325bn.[9] Even though building societies remain a significant part of the financial sector, since the 1980s the financial sector as a whole has become demonstrably less diverse, with the plc model becoming the dominant banking model in the sector.

This is in contrast to the situation elsewhere in Europe. Unlike the UK, most European countries have a considerably more mixed financial system when it comes to corporate models and ownership structures. In Europe, there has long been a distinction between those institutions that could be called ‘shareholder banks’ and those that could be considered ‘stakeholder banks’. The former can be categorised as those banks whose primary purpose is to maximise shareholder value and the rate of return on equity – as with those that operate under the plc model. In contrast, with stakeholder banks, while profit is required to finance future growth, it is not the exclusive or even primary purpose or objective. In practice, this means that stakeholder banks, of which building societies are a part, will not pursue profit maximisation to the same degree or with the same intensity as plc banks.[10]

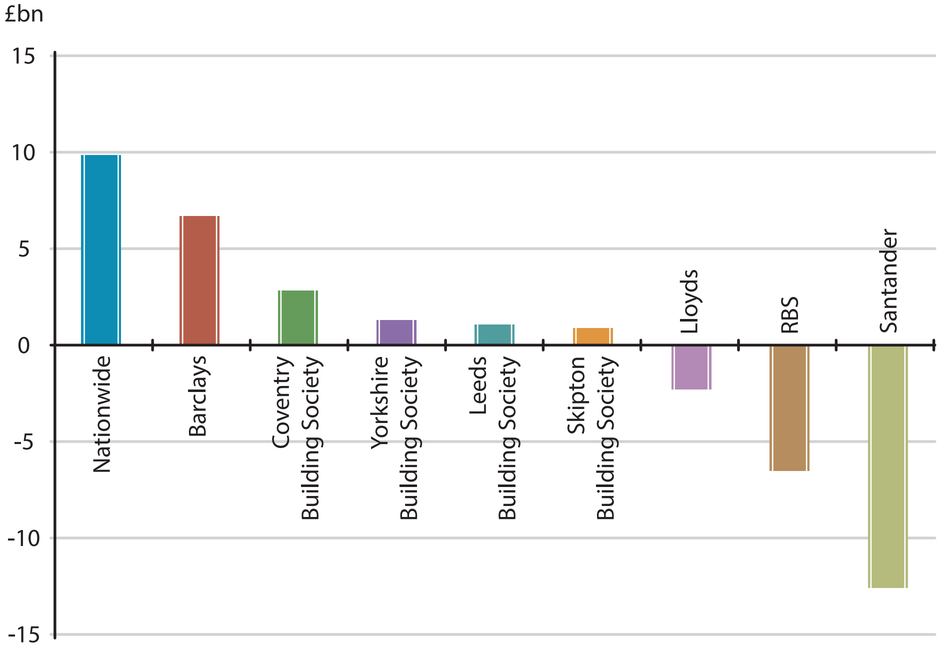
Stakeholder banks, such as co-operative banks, building societies, credit unions and other financial mutuals, play a substantial role in most European economies and, in contrast to the experience of building societies in the UK, have increased their share of banking business over the past ten years. Five EU member states (including France and Germany) have more than a 40 per cent share of co-operative or mutual banks in terms of branch networks.

An IMF study finds that the overall market share of co-operative and mutual banks in terms of total banking sector assets increased from about 9 per cent in the mid-1990s to about 14 per cent in 2004.[11] Compare this to building societies in the UK, which, despite providing an invaluable service to their customers and their communities, account for only 3 per cent of total banking assets.[12]

The experience of continental European countries in the balance between shareholder banks, like plcs, and mutual banks is instructive. As are the reasons as to why mutual banks do so well on the Continent in comparison to the UK. The capital raising powers of European stakeholder banks is much greater than that currently possessed by British building societies currently possess, with European stakeholder banks being able to raise additional capital needed for expansion through financial instruments that are mostly absent from the UK market.[13] The recent introduction of Core Capital Deferred Shares is a welcome development from the sector, but current regulatory constraints make it difficult to open these share offers to retail customers. Further, in addition to these capital raising issues, the business of building societies in the UK is a lot more restricted than in Europe. Stakeholder banks in most EU member states are permitted to compete with standard banks across a full range of business, including corporate lending.[14]

An in-depth review and study found that having a strong presence of stakeholder banks enhances competition in the financial sector, increases market

Fig. 1 Cumulative Net Lending Since 30/06/12 (£bn)



Source: Bank of England (2013) Funding for Lending Scheme – Usage and lending data[Online]. Available at: http://www.bankofengland.co.uk/markets/Pages/FLS/data.aspx [Accessed 15 January 2014].

stability, contributes to alleviating social exclusion and, because oftheir local focus, contributes meaningfully to regional economic development.[15]

Further, it has been found that there exists very little difference between the two types of banks in terms of efficiency,[16] and that mutual banks are more stable financial entitles (mostly because they have a lower volatility of earnings then plc banks do).[17]

As building societies are by nature more responsible custodians of their members' money, they were not as hard hit by the financial crisis as were the large plc banks, many of which had to be bailed-out by the taxpayer. The positive consequences of this can be seen in the results of the Government's Funding for Lending scheme, which has been designed to boost banks and building society lending. The scheme does this by providing lending to banks that is linked to the banks' own overall lending performance.[18]

Since the scheme was introduced in July 2012, building societies have increased their lending 5 per cent (or £15.7bn), whilst the top high street banks under this scheme have seen their lending fall by 1.5 per cent (or £12bn).[19] Clearly, building societies are outperforming banks in providing credit to consumers in need.

This is not to say that there are not good reasons why different corporate forms coexist within the same marketplace, and some banking and ownership models are more suited to certain operations than others. But clearly, a banking sector that is more diverse, more competitive and focuses much more on its customers can only be beneficial for consumers and society at large. Supporting the growth of the building societies sector could be a good way of achieving the vision for a more civic-focused financial sector.

In *The Future of Building Societies* consultation, HM Treasury has given some indication that it is willing to lend its support to the sector. In this consultation, it was put forward that the building societies sector must be able to compete in the future world of financial services.[20] As part of the consultation, the Government committed to assessing how the legislative framework underpinning building societies can be amended to help create a more level playing field.

Levelling the playing field

In the wake of the financial crash, the international community made it a key priority to determine how the global financial system could be made inherently more secure. One key recommendation that came out of top-level discussions at the international level, was to enshrine in law the stringent Basel III set of banking standards that detail the macroprudential leverage ratio requirements for financial institutions. In Europe, these will be enacted at the EU level and not by Member States. As part of this commitment, the Council of the European Union has asked the European Banking Authority (EBA) to establish the exact methods by which these requirements will be calculated, including a means of differentiating between different business models.[21]

A system of differentiated system of leverage ratio requirements could, in principle, allow regulation to be better tailored towards those financial institutions with lower risk profiles, including building societies. But, as the EBA will not be reporting on this until 2016, there exists a lack of certainty with regards the capital requirement commitments that building societies will have to adhere to. Grouping building societies together with larger banks would have the effect of making many building societies uncompetitive, to the detriment of banking customers, their families and the wider community.

It is our recommendation that, as part of its overall building societies strategy, the Government should introduce a 'trigger' policy. Under this, any reforms to the financial sector that are focused primarily on banks will trigger a compulsory review of building societies legislation to determine how these new proposals might, in turn, impact on the building societies sector. There should then be an obligation on the part of HM Treasury and the regulators to ensure that any subsequent negative consequences are mitigated. In keeping with the aims of ensuring healthy diversity and competition, the Government should be obliged to maintain a level playing field between the stakeholder and shareholder components of the financial sector. These changes could be introduced by strengthening the currently minimal requirements contained within s.138k(2) of the Financial Services and Markets Act 2000 via an amendment included in the soon to be introduced Co-Operatives Bill.

Looking ahead, in light of current reforms focused on leverage ratios, it is clear that such a 'trigger' would have consequences for current Government policy. The Chancellor of the Exchequer recently issued a letter to the Financial Policy Committee of the Bank of England to examine whether the Committee should be given greater powers over the setting of capital requirement leverage ratios.[22] In light of this request, we would stress that HM Treasury, in expectation of the EBA announcement on differentiated ratios in 2016, take into consideration the position of building societies when they decide whether to grant the FPC additional powers. The Government had taken into consideration the particular situation of building societies when agreeing not to subject building societies to the new ring-fencing legislation contained within the Banking Reform Act. We recommend that the Government adopt such a practical and reasonable approach to leverage ratio requirements as well.

In short, we think it highly appropriate that the regulators develop an approach to financial reform that factors in the specific needs of the building societies sector and recognises the generally low-risk characteristics of building society business models. If the Government is serious about creating a more diverse, competitive and consumer-focused financial sector (as we argue with our own *Civic Approach*), then it is vital that building societies form a key focus of current and future reforms. It is, therefore, our recommendation that the Government, not only take this into consideration building societies with regards granting new powers to the FPC, but also apply suitable pressure on the relevant European bodies to ensure that a level playing field is established for building societies with regards leverage ratio requirements. It is also our recommendation that the UK Government lobby the EU Commission and EBA to ensure that building societies are placed in a risk profile bracket that better suits their inherent risk in relation to banks.

Alongside a 'trigger policy', we recommend that the Government explore how the playing field could be levelled in the current account market. The Government has already expressed its commitment to open up the UK payments system – the system that links all bank account held by UK financial institutions. The current payments system has been criticised for being non-transparent and uncompetitive in nature.[23] Under new proposals, the Government has committed to creating a new Payments Systems Regulator that will oversee the system of payments in the UK to make the system more affordable for smaller banks and building societies.[24] These changes clearly have the potential to be beneficial to building societies.

Traditionally, current account services have not been offered by building societies (for instance, Nationwide, the UK's largest building society, only accounts for approximately 6 per cent of market share).[25] The greatest barriers to entry for building societies wanting to enter the current account market have typically been the high technology costs associated with linking to the current payments system and the fact that, because of perceived risks and uncertainties, many customers do not switch accounts.[26] The latter concern has mostly been remedied by the Current Account Switch Service, which enables customers to switch their current accounts within 7 working days.[27] Since its introduction, building societies, particularly Nationwide, have proven to be the biggest beneficiaries of this switching service. But there still remains the high technology costs associated with market entry.

Since the financial crash, the current account market has seen the four largest banks in the current account market increase their market share to 75 per cent.[28] Bearing in mind the uncompetitive state of the current account market and the impending reforms to the UK payments system, we recommend that HM Treasury, when establishing the new Payments Systems Regulator, establish a distinct building societies strategy to establish how a new, more open payments system could be structured to benefit building societies and their customers.

SME finance

A potential area of the market that is currently less catered for by building societies is the corporate finance market – in particular SME lending. It is a well-established fact that most smaller firms rely on credit to help plug the holes in their finances.[29] By 2017, it is highly likely that the funding gap between the amount of finance that SMEs need and the amount they actually receive will be as high as £22bn.[30] Since the Crash, SME lending has fallen by more than 25 per cent,[31] and loan rejection rates in the UK are twice that of our major European competitors: France and Germany.[32] The latter is not surprising at all considering how much more prominent stakeholder banks are in those countries, with all the benefits of competition and diversity this brings.

Clearly, there is a demand for new corporate finance providers. But building societies are currently constrained by what they could do in this regard by the Building Societies Act. The provisions are strict in stressing that at least 75 per cent of loans must be secured on residential property. This does not exclude SMEs from taking out loans if they secure against personal or commercial property of owners (and some building societies do currently offer these types of loans to SMEs), but it does preclude many SMEs from applying for loans. This puts building societies at a disadvantage in comparison to plc banks.

There currently exists the possibility of HM Treasury to, via secondary legislation, amend this minimum requirement to 60 per cent. We recommend that the Government do this as an emergency measure to both immediately increase competition in the corporate lending market and to ease credit conditions for SMEs. In the longer term, we recommend that the Government explore the possibility of reducing this limit to 50 per cent of loans secured against personal property via an HM Treasury instigated review, which is low enough to encourage building societies to embrace SME lending, but not so low as to compromise their mutual character. These changes should in turn be reflected in the PRA Building Societies Sourcebook.

As a comparison, in the mortgage market building societies have been performing extremely well in tough market conditions. In the first seven months of 2013 gross lending by the sector rose by £22.2bn, up 30 per cent compared to £17.1bn in the same period last year. This gives mutuals a 24 per cent market share of gross lending in the year to July, up from 21 per cent in the same period in 2012.[33] If building societies were to have their constraints loosened, there is a good possibility that they could develop a similar presence in the corporate lending market – to the benefit of many beleaguered SMEs.

However, it must be recognised that the loosening of these "nature limits", although this would undoubtedly be a big step in the right direction, is not in itself sufficient to kick start building society SME lending; nor does the responsibility for reform purely rest on the Government's shoulders. The industry itself will need to develop new skills and enhance its capabilities if it is to develop a comprehensive SME finance offer. So, in conjunction with any moves by HM Treasury to loosen the nature limits, we would challenge the industry to be bolder in its moves to increases its corporate product offer. Any reforms introduced by the Government must be met half way by the building societies sector.

"Soft" mutualisation and remutualisation

There is one area of financial regulation, perhaps more than any other, that is tilted towards plc banks at the expense of building societies. The Building Societies Act introduced, amongst other things, the provision for building societies to exit the market, demutualise and convert to plc bank status. The effect this had on the sector has been detailed above, with eight of the top ten building societies converting to plc status since enactment. The situation whereby building societies can choose to leave the sector fairly easily has left the sector in an unsatisfactory position. Not only do firms that have demutualised not have an easy path back to the mutual sector, building societies themselves do not find it easy to enter other markets because of the limits placed on them.

Over recent years, some efforts have been made to loosen the restrictions placed on building societies. The Building Societies (Funding) and Mutual Societies (Transfers) Act 2007 (known as the "Butterfill" Act), made it easier for building societies to merge with organisations that are subsidiaries of other types of mutual.[34] Further, there exist provisions under the Financial Services and Markets Act 2000 (FSMA) that permit banks to transfer certain aspects of their company to a building society.[35] Even though both pieces of legislation can be helpful to building societies, they do not fully remove those barriers that stop building societies from operating on a level playing field. The "Butterfill" Act effectively only permits the merger of a building society with a bank which is a subsidiary of another type of mutual (there are not many of these), and the FSMA transfer provisions can only be activated by a bank (and do not apply to transfers of business from a building society), and even then that requires a court order.

The Building Societies Act does allow for building societies to acquire or establish organisations that are not building societies, subject to the Board's approval (certain building societies have acquired Independent Financial Advisor businesses for instance). However, where the greater part of the business acquired or established has not connection with residential mortgage lending or the greater part of the income is derived from, or resources are devoted to, activities having no such connection, and where the acquisition or establishment would cost 15% or more of the society's own funds (regulatory capital), member approval must be sought (an "ordinary resolution"). As outlined above, building societies are also restricted by certain "nature limits". Under these limits, building societies and their subsidiaries would be unable to acquire, in whole or in part, other financial businesses where the acquisition would result in the building society (when looked at on a group basis) being unable to satisfy any of these limits or where the activities of the business would cause the society to be in breach of provisions which restrict the transaction it may undertake.

Increasing diversity in the financial sector, with the benefits to competition and customer service that this would bring, will be extremely difficult – if not impossible – without some loosening of building society nature limits. We recommend that changes be made to the Building Societies Act that permit building societies to own shares in, either directly or through a holding company, retail banks that do not trade in securities, commodities or currencies. This includes those banks, or parts of banks, which operate as "High Street" banks, i.e. focus on savings and loans, or provide current accounts and other basic banking services. This would not include investment banks and the like, as this would compromise the purpose upon which building societies were first established, namely, to provide personal loans, mortgages and savings. The Government could make these changes by removing the nature limit elements of the Building Societies Act that apply to subsidiaries of building societies.[37] These amendments could also be adapted to include banks, or subsidiaries of banks, that are based in EU member states.[38] This would open up the European market to UK-based building societies.

As it is absolutely vital that the underlying mutual purpose of the parent building society is not compromised, under these proposals certain requirements would have to be met in order for an acquisition to be permitted by the regulators. Firstly, if a building society is to purchase a stake in a bank, then the building society in question, or a holding group that it owns, must purchase at least a controlling share in that firm. This way a building society can ensure that the newly acquired subsidiary does not stray outside its "High Street" functions and compromise the spirit of the Building Societies Act. Secondly, any purchase of a bank's shares must be approved by a vote of members in which at least 75 per cent of those who vote do vote in favour (in a similar fashion to the rules governing demutualisation[39]). This is so that the democratic and co-operative principles of building societies are not breached. Finally, all net profits not retained as investment by the subsidiary or paid out as dividends to other investors, as well as all dividends on shares received by a holding company, must be transferred to the parent building society. This is to ensure that the mutual nature of the apex building society is not compromised, and that their members directly benefit from the acquisition of the bank through cheaper and more wide-ranging services.

Measures such as those mentioned above, while they would not permit the full mutualisation or remutualisation of banks (which would be difficult to achieve), would nevertheless allow building societies to act as owners of non-mutual financial institutions through what could be considered "soft" mutualisation or remutualisation, as there would then be non-mutual financial institutions owned and controlled by mutual building societies.

Provided that the aforementioned requirements are adhered to, we believe that this will increase diversity and competition in the financial sector without undermining the basis upon which building societies function. The Government could make these amendments to the Building Societies Act through the soon to be introduced Co-operatives Bill.

One particular area where such legislative changes could reap almost immediate benefits could be with the flotation of the newly-formed TSB Bank. In a review of Lloyds Banking Group following the UK Government's attempts to keep the beleaguered bank viable through the purchasing of preference shares, the EU Commission ruled that Lloyds Banking Group must divest 631 branches of its network into a new and separate banking entity.[40] The new TSB Bank, will be a retail focused high street bank intended to increase competition in retail banking and will float in summer 2014.[41] This represents a great opportunity for a building society (or a consortium of building societies) to make a bid for a controlling share of the newly formed bank once it floats. This would both significantly strengthen the building societies sector, with all the benefits to their many customers that this could bring, and ensure a greater level of diversity within the retail banking sector as a whole.

3. Promoting Mutual Societies

"Prior to the emergence of the Welfare State and the establishment of the NHS, mutual societies played an important part in many people's lives. Indeed, in Britain friendly societies were one of the most important providers of welfare and health insurance during the early part of the twentieth century."

Friendly societies, sometimes called benevolent societies, are mutual organisations established for insurance-like purposes.[42] They, just like building societies, are owned by their members, and usually practice benevolent or charitable functions alongside the services that they offer. Friendly societies and mutual insurers (together known as mutual societies) form a crucial alternative to large, often international plc insurance firms.

Prior to the emergence of the Welfare State and the establishment of the NHS, mutual societies played an important part in many people's lives. Indeed, in Britain friendly societies were one of the most important providers of welfare and health insurance during the early part of the twentieth century. In 1910 there were 26,877 mutual societies and 6.6 million registered members (more if you include unregistered members). This amounted to 1 in 8 of the population at the time.[43]

But from their height at the beginning of the 20th Century, friendly societies have gone into a decline. The establishment of the NHS and the Welfare State in the Post-War period significantly undermined the business model of many financial mutuals. Further, in a similar fashion to building societies, friendly societies also underwent their own demutualisation process.

In 1995, over half of the UK insurance market was mutual. Since then, mostly due to the demutualisation process, the mutual insurance sector has shrunk to around 7.5 per cent of the total insurance market.[44] Unlike the building societies sector, however, this did not happen as a direct result of recently-passed legislation. Demutualisation of the mutual insurance market occurred, not because of an immediate rush to capitalise on the potential windfalls presented by recently passed legislation, but because of the need for mutual insurers to either raise capital and improve their product ranges in an expanding market, or because banks viewed the purchasing of a demutualised mutual society as a good opportunity to enter the life assurance market.[45] It could be argued that the strict rules and regulations placed on friendly societies contributed substantially to their demise and perhaps even made it inevitable. Indeed, these market conditions initiated an exodus of mutual societies from the sector.

Some of the large mutual insurers, Norwich Union, Friends Provident, Standard Life, Scottish Provident and Scottish Widows all chose to demutualise either as a stand-alone institution or in order to be acquired by a larger, non-mutual firm.

As with the building societies sector, the widespread demutualisation of mutual insurance has generally not been beneficial to customers. Customer research of demutualised friendly societies indicates that policyholders have seen falling levels of customer service, higher levels of complaints and worse claims handling than was experienced prior to demutualisation.[46]

Also, despite initial windfalls, demutualisation has been all-round detrimental to many policy holders. Take Scottish Widows, for example, which when it converted to plc status in 2000 paid out £6,000 to each policyholder as a windfall. As one of the leading mutual insurers and a significant player in the wider insurance market, prior to demutualisation it paid out £107,941 in 1998 for a 25 year with-profits policy, based on premiums of £50 a month. From statistics posted in 2012, this had plummeted to £28,071, which was more than 34 per cent less than the average mutual.[47]

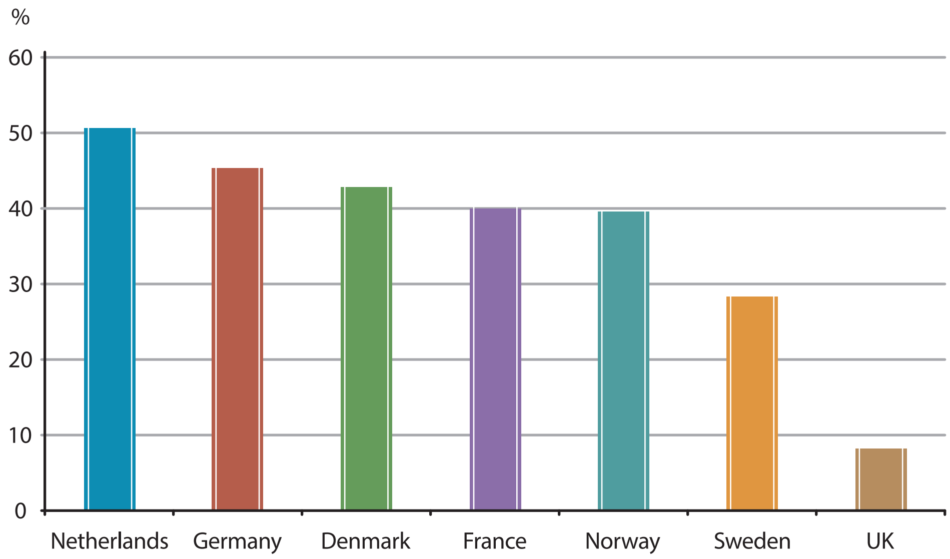
Despite the demutualisation of many larger societies, mutual societies and insurers still possess a meaningful presence in the insurance market, particular when it comes to serving those on lower incomes. There are currently 200 mutual insurers and friendly societies in operation, with around £100bn of funds under management. As previously noted, mutual societies make up about 7.5 per cent of the UK insurance market.[48] But despite there still being a meaningful presence of financial mutuals in the insurance market, this is obviously a long way from the market dominance mutual insurers once possessed in the early 1990s. Further, this situation is in stark contrast to other European insurance markets. In the EU, mutual insurance firms account for over half the market share in many member states and, on average, the mutual insurance sector amounts to approximately 25 per cent of the total European insurance market.[49] [*See Figure next page.*]

The UK clearly lags behind other European countries when it comes to a mutual presence in the insurance sector. Having such a homogenised sector dominated by a single type of ownership model, in this case plcs, seriously weakens competition and diversity in the sector, with all the implications for customer service that this entails. If, as we argue, the Government is to adopt a Civic Approach to financial reform and create a more diverse, competitive and customer-focused financial sector, then more needs to be done to promote friendly societies and other mutual insurers. A more diverse and competitive insurance market, with a financial mutuals presence analogous to the market share that financial mutuals enjoy in other European markets, can only be beneficial for customers and society as a whole. The rest of this section details how policy makers can help to bring about this change.

Unleashing capital for mutual societies

As was mentioned above, one of the key drivers for the demutualisation of friendly societies was the need to access greater amounts of capital. It still remains a salient problem for all financial mutuals that because of their mutual and non-shareholder-based ownership models, they have difficulty in raising additional or outside capital. This potentially hinders financial mutuals that wish to expand or develop additional financial products. At present, mutual insurers and friendly societies tend to be relatively well-capitalised. However, new product developments or tactical acquisitions usually require significantly higher levels of additional capital, and mutuals currently lack access to appropriate capital raising vehicles. The

Fig. 2 Mutual Insurance Market Share



Source: International Co-opertaive and Mutual Insurance Federation (2011) Global Mutual Market Share [Online]. Available at: http://www.icmif.org/wp-content/uploads/2013/05/Mutual-Market-Share-2011.pdf [Accessed 14 Jan 2014].

situation whereby mutual societies are overly constrained by current legislation prevents the growth of the sector to the detriment of both customers and their communities.

The Mutuals' Redeemable Shares Bill, drafted in July 2013, could go some way in rectifying this unsatisfactory position. This Private Members Bill, introduced by Lord Naseby, if passed would create a legal framework through which financial mutuals could issue redeemable shares to raise additional funds. It draws for its inspiration, on similar legislation that exists in Canada and the Netherlands that allow financial mutuals to compete on a more level playing field with their shareholder counterparts.

Even though this Bill would allow institutions and individuals to invest in financial mutuals, as well as allowing existing members to take advantage of such schemes, it would safeguard the mutual nature of mutual societies by ensuring that those investors who hold redeemable shares are not entitled to vote on matters relating to the transfer or merging of a financial mutual. In this way it strikes a good balance between the capital requirements of financial mutuals and the need for these mutuals to stay true to their democratic and co-operative principles. The Bill would pave the way for mutual societies to raise finance for both for the expansion of services and for investing in socially beneficial causes, as per their original founding purposes.

When seeking to raise additional capital, there is one area in particular in which mutual societies could have a significant impact in a way that they cannot at present: the area of social and community investment. ResPublica detailed the possibility for local authorities, Local Enterprise Partnerships (LEPs) and other local investment bodies to fund community or infrastructure projects through vehicles we termed Community Infrastructure Bonds.[50] These are bonds intended for investment in local projects that are constructed and underpinned by a suite of revenue streams, including investments from local government, LEPs, financial mutuals, third sector organisations and private investors. These bonds would in effect pool local investment resources around a single product for investment in local projects.

It is through Community Infrastructure Bonds, or perhaps through some form of hybrid municipal bond, that friendly societies could invest in local and community projects alongside local government or other public sector bodies. Such a move would restore the ability of mutual societies to perform a transformative role in society, whilst at the same time generating a healthy return for all those mutual societies involved.

Another potential option for friendly societies could be to invest in the burgeoning social impact bond market and its associated products and initiatives. These financial products are an outcomes-based investment product in which public sector commissioners commit to pay for significant improvement in social outcomes (such as a reduction in offending rates).[51] As with municipal bonds or Community Infrastructure Bonds, these investment products could provide the means by which mutuals can ensure a return on investment for their members whilst remaining true to the social purposes upon which their society was founded. The nascent market would also benefit hugely from the influx of investment that mutual societies could bring, ensuring that this infant market develops into a mature, fully-functioning market in social investments.

In light of the potential for friendly societies to become much more involved in social and community investment, it is imperative that the legislation concerned with unleashing capital for friendly societies is passed. It is for this reason that we recommend that the Government throw its support behind the Mutuals' Redeemable Share Bill currently making its way through Parliament. If the Government does not do so, we recommend that similar provisions be included in the Co-operative Bill when it is introduced to Parliament.

Establishing deep networks of friendly societies

Apart from a lack of demutualisation legislation, another good reason why mutual insurers have more of a presence on the Continent is because our European counterparts are much more able to compete with non-mutual insurers on issues of scale. Non-mutual insurers are able to benefit from large capital injections due to their shareholder model, which is counterbalanced by mutual insurers in Europe making use of a type of institution unique to mutuals there known as Central Network Institutions (CNIs), the existence of which is the key reason why there is a strong mutuals presence in the financial sectors elsewhere in Europe, the US and Australia. On the other hand, they are completely absent from the UK market and this may have contributed to their lesser role compared to most other European countries.

CNIs are organisations that host networks of co-operatives or mutuals under an umbrella organisation. One example in banking is Rabobank in the Netherlands, which is not a single bank but in fact a confederation of 52 'little Rabobanks' that pool their resources under one brand for the benefits of customer recognition and economies of scale. An example of such a model in the insurance market are French Mutual Insurance Group Companies (SGAM), which allow smaller mutual insurers to pool their resources so that they can compete on a more equal footing with their shareholder rivals. As a legal entity, SGAMs are non-proscriptive in their membership requirements and beyond a basic level of mutual and co-operative agreement, mutual insurers in France are, under this model, free to choose how a SGAM will co-ordinate between members. Such a flexible model could aid co-operation between friendly societies in the UK as well.

Regardless of model, all CNIs enable smaller financial mutuals to centralise or outsource certain key functions such as IT support, accounting, marketing, product development and risk management.[52] In Europe, many of these network organisations have themselves evolved into larger financial conglomerates that are amongst the largest financial groups in those countries.[53] Indeed, a key defining characteristic of financial mutuals in Europe is their reliance on CNIs to achieve economies of scale and compete with non-mutual financial institutions.[54]

There are several clear advantages to utilising CNIs more in the UK. Firstly, friendly societies would benefit from economies of scope and scale with respect to administrative and back office functions. Secondly, a quasi-management consultancy role is often performed by CNIs, so that best practice is effectively disseminated throughout the network, benefiting all members. Thirdly, many of the CNIs have very strong reputational and brand awareness, often beyond those of their constituent members. In this way, customers feel more at ease or secure with working with smaller mutual societies if they are part of a more distinguished whole.[55] A good example of an organisation that performs such an umbrella role in the mutuals sector is Australia's Cuscal.[56] UK financial mutuals could benefit from more formal arrangements that run along similar lines to Cuscal of the French SGAMs, and this is something for the Government to review.[57]

The fact that the UK mutual societies market is made up of a large number of smaller societies means that the sector would benefit significantly from CNIs. The top 5 mutual insurers have around 80 per cent of the sector's managed fund, and over 90 per cent of mutuals have assets less than £1bn.[58] Whilst the larger mutual societies will not need umbrella network institutions to operate within, many of the smaller societies would certainly benefit from greater and more formal co-operation. Furthermore, as these groups would still only comprise a fairly small portion of the market, UK competition law would not be compromised.

As the Friendly Societies Act 1992 currently makes it possible for friendly societies to transfer any part of their business to industrial and provident societies, companies and other mutual and non-mutual insurers[59] – so legislative change in this regard is unnecessary. But HM Treasury should consider initiating a programme that would act as an incentive for smaller friendly societies to form CNIs.

In operation, this would be similar to the Department for Work and Pension's Credit Union Expansion Project (CUEP), which is designed to raise the capability of credit unions by encouraging the sector to upskill, improve its culture and introduce new automated systems through the injection of public financing.[60] The CUEP is not expensive (£51m in total),[61] and a similar scheme could be established for friendly societies and mutual insurers. This would, in turn, bring benefits to wider society through bringing increased competition and diversity to the financial sector. We recommend that HM Treasury consider establishing a Financial Mutuals Growth Fund to assist with the establishment of umbrella groups and network institutions. As too many mutual societies and insurers operate in isolation, Government policy could assist greatly in remedying this problem.

Combating financial exclusion

Financial exclusion is a particular problem for many households, especially with the squeeze on domestic finances still ongoing. Curtailing financial exclusion is one area in particular where mutual societies, as inherently social and benevolent societies, could take the lead in. Products that help to alleviate financial exclusion, such as basic savings, household insurance and private pensions, are products that many mutual societies currently lead in. However, more can be done by Government to assist mutual societies tackle financial exclusion.

One large impediment to the expansion and take-up of basic financial products are the reforms that were ushered in by the Retail Distribution Review. In January 2013, new rules from the FSA (as it was then) came into effect that changed the way financial advisory companies operate. Known as the Retail Distribution Review (RDR), the objective is to raise professional standards in the industry, introduce greater clarity between the different types of services available and make the cost of advice clear and explicit.[62]

However, there is debate over whether these new rules will create a 'post-RDR advice gap' as the new regulations will reduce the number of high street advisors and encourage a focus on more wealthy clients.[63] With advisors no longer able to receive either commission or on-going commission payments, they will charge a regular set fee and will choose clients who will be able to afford these upfront.[64]

With these new rules, low or middle-income class earners are likely to find it harder to receive advice or will be entirely excluded.[65] RDR rules also enforce tougher rules for qualification, a move that has already seen a number of banks cease to provide financial advice, causing many big names on the high street to cut back on face-to-face financial advisory services, or withdraw them altogether,[66] leaving middle and low income earners with fewer options for financial advice. For example, RBS blamed the new rules for its decision to cut 618 advisor jobs, Lloyds TBS stopped face-ta-face advice for anyone with less than £10,000 in assets and HSBC cut 700 jobs owing to the new rules.[67]

A solution to this 'advice gap' was presented by the FSA during the review process. The FSA established guidelines for what it termed 'simplified advice'. This type of advice describes a streamlined and simple form of advice that aims to address the straightforward needs of a particular customer without assessing the surrounding circumstances of that customer.[68] This type of advice is suited to those who would want advice on specific financing product, such as those who simply wish to purchase more simple financial products, which are offered by many mutual societies.

The main problem with 'simplified advice', and a key reason as to why so far there has been very little take up of this type of advice, is because at the time the FSA explicitly ruled out providing an exact definition as to what this type of financial advice would comprise.[69] So, where 'simplified advice' could potentially have been a means by which mutual societies and other financial institutions could provide advice to those seeking guidance on individual and often basic products, we have instead the situation whereby, due to a lack of definition on the FSA's part, many of those who are on lower incomes and in urgent need of financial advice are excluded from the advice market.

In light on this, we recommend that the Financial Conduct Authority, in its role as consumer champion, make it a priority to establish clear guidelines as to what exactly is meant by 'simplified advice'. This should make it far easier for financial firms, including mutual societies, to provide advice on basic and simple financial products. This would greatly reduce current levels of financial exclusion and go some way to making the financial sector, as a whole, more responsible and responsive to customer need.

4. Promoting Community Finance

"There are now a large number of customers and communities that are under-served by mainstream financial institutions. It is this void that community finance institutions attempt to fill."

Since the onset of the financial crisis, financial provision for many parts of society has been severely limited. There are now a large number of customers and communities that are under-served by mainstream financial institutions. It is this void that community finance institutions attempt to fill.

Community finance is defined as loans and credit provided at an affordable rate to markets under-served by mainstream finance.[70] There are several types of organisations in the sector that attempt to meet this under-served demand, but the two dominant types are credit unions and Community Development Finance Institutions (CDFIs).

Credit unions are not-for-profit mutual finance institutions democratically controlled by their members. These institutions mostly focus on the personal finance market and provide personal loans, savings and bank account services. There are approximately 400 credit unions in Britain managing almost £1bn worth of assets.[71] Despite a sizeable market presence, and the fact that credit unions represent a good alternative to households in need of financial services, the services many credit unions offer are limited. Only 22 credit unions offer current accounts and many others offer only a limited range of services.[72]

The Government is aware of this problem and has, through the Department for Work and Pensions (DWP), established the Credit Union Expansion Project to explore how credit unions could be encouraged to expand and develop their capabilities. This move is to be welcomed but, as this is an on-going project from which so far there is limited feedback and evaluation, the remainder of this section of the report deals with CDFIs, which have as yet not received the same level of attention. Nevertheless, we do believe that credit unions have the potential to make a significant contribution in the area of promoting community finance.

Community Development Finance Institutions are providers of community finance that mostly specialise in providing loans and advice to businesses, households and civil society organisations. CDFIs prioritise disadvantaged communities and focus their efforts in improving economic opportunity, alleviating poverty and regenerating neighbourhoods. CDFIs have so far received little attention from policy makers and reform of the sector has occurred in a piecemeal manner. None of which is beneficial to those suffering the consequences of economic exclusion.

Lower income households are unlikely to see their earning return to pre-2008 levels to at least 2018.[73] In a situation where earnings are depressed in relation to prices, credit is a crucial way of making ends meet. But consumers are grossly under-served in this department. Lending to consumers from high street banks is still down on 2008 levels,[74] and demand is by far outpacing supply.[75]

UK businesses are not fairing much better either, especially our smaller firms. Small and Medium-sized Enterprises (SMEs) classified as a single group represent 99.9 per cent of all private businesses, 59.1 per cent of private sector employment and 48.8 per cent of private sector turnover.[76] As we pointed out in a ResPublica report published last year,[77] SME lending has fallen by 29 per cent since 2009,[78] and of those SMEs who applied for credit 23 per cent had their loan applications rejected.[79] Many of our smaller business are clearly suffering because of a lack of available credit.

CDFIs can help enormously with those lower income households and smaller businesses that currently lack access to suitable finance. Because they operate on a more personal, one-to-one basis, most CDFIs can take the time to ascertain the credit worthiness of individuals and businesses that goes beyond standard banking practice. This allows them to lend to those who would traditionally be considered “risky”.

In contrast to what has happened with most high street banks, CDFIs have actually increased the amount of credit available to consumers and businesses. Since the financial crash, the total value of loans issued by CDFIs has increased by 256 per cent.[80] There has been, mostly due to exclusion from standard forms of credit, a doubling of interest in CDFI finance since 2010.[81]

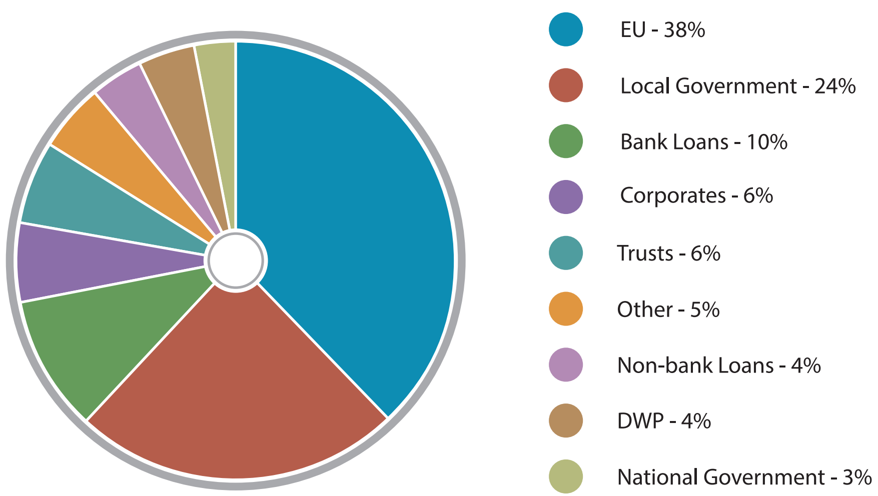
CDFIs have traditionally focused on SME lending, and for many CDFIs corporate finance remains the core lending output. In 2012, CDFIs lent £30.2m to over 2,600 businesses, helping to create 1,797 businesses and safeguard 570 smaller firms.[82] CDFIs have been similarly impactful with consumer lending. Last financial year, community finance institutions lent out £11.4m to 28,992 people, saving 17,105 customers from high-cost loans and rescuing 1,740 people from illegal money lenders.[83]

Clearly, CDFI are doing an admirable job in catering for those who are under-served by mainstream finance. But the trade body that represents CDFIs, the Community Development Finance Association (CDFA), estimates that this is just the tip of the iceberg of what community finance institutions could provide. They estimate that the current potential annual demand for all community finance in the UK is somewhere between £5.45bn and £6.75bn. This is in stark contrast to the £200m of finance that was actually delivered by community finance organisations in 2012.[84] Obviously, much more needs to be done to aid CDFIs expand and fulfil this demand. The Government has a key role to play here.

Adequately capitalising CDFIs

Community finance institutions have approximately £100m of capital.[85] The sources of this finance are varied. The majority (69 per cent) of the financing CDFIs receive originates from the public sector, the bulk of which is EU financing distributed through the

Fig. 3 CDFI Funding - Annual Capital Received to On-lend 2012



Source: Community Development Finance Association (2012) Inside Community Finance: Annual survey of CDFIs in the UK [Online]. Available at: http://www.cdfa.org.uk/wp-content/uploads/2012/07/Inside-Community-Finance-June-2012.pdf [Accessed 14 January 2014] p.16.

Regional Growth Fund. Local Government financing also makes up a large part of public CDFI financing. Bank loans, corporate and individual investments comprise the remainder of the financing.[86]

The reliance of the community finance sector on public sector financing does hinder the sector's ability to grow. The long term outlook for public sector spending is for public expenditure to either remain flat or decrease even further. This significantly hinders the potential expansion of CDFIs, as they rely so heavily on public financing, and presents a formidable barrier to growth. The only means by which the sector can match the over £5bn worth of demand is to increase the amount of financing they receive from private sources. In this regard, CDFIs in the UK are at a distinct disadvantage in relation to their US counterparts.

The modern community finance movement originated in the US, where CDFIs have been operational since the early 1990's. There, under the auspices Community Development Financial Institutions Fund, US CDFIs receive a significant amount of funding from US Federal and State sources ($1.3bn in 2012)[87]. But US CDFIs also receive large amount of private financing. The US public sector fund is complimented by private investment measures derived from the provisions of the Community Reinvestment Act 1977 (CRA).

The CRA is intended to encourage depository institutions to help meet the credit needs of the communities in which they operate. Its intent is to require large financial organisations to engage and invest in people and businesses in low and moderate-income areas. The CRA also requires the appropriate regulator to assess a bank's record of helping meet the credit needs of its entire community. Through the Community Reinvestment Act, US CDFIs received $68.5bn in investment in the period from 1996 – 2009.[88]

By evaluating the community investment of financial institutions, banks are required to ensure they are reinvesting in the local economies they serve. In the UK, banks could achieve this indirectly by investing in CDFIs, who will be more able to allocate the needed funds using their local knowledge and expertise. In essence, CDFIs are perfectly placed to be a vehicle for the community investment for the large banks, which often do not lend to SMEs or social entrepreneurs due to a perceived lack of profitability in doing so, and do not lend at all to microenterprises. Such a move would significantly increase the funds available to CDFIs and go a long way towards helping them meet the potential demands from consumers and small businesses.

In light of this, it is our recommendation that all three main political parties promise to introduce a UK version of the Community Reinvestment Act in their General Election manifestos. Given that the banks are finding it difficult to lend to riskier consumers and businesses, and will continue to find it so in the longer term, the introduction of a Community Reinvestment Act in the next Parliament could potentially transform the lives of many of Britain's poorest communities and small businesses. It should form a key plank of any serious attempt to reform the financial sector and will ensure the sector become more geared towards the needs of communities. A UK version of the Community Reinvestment Act could act as a Consolidation Act and a sensible means through which initiatives like Funding for Lending, the Project Merlin agreement, the British Business Bank, BBA postcode lending data and the BBA/CDFA referral system could be brought under one heading; and by doing so ensure a more efficient and cost-effective means of directing funding to CDFIs. The FCA should then be handed the regulation of this new regime to ensure that our SMEs and communities are adequately catered for, be that directly or through institutions like CDFIs.

Alongside the introduction of a UK Community Reinvestment Act, some legislative measures would have to be taken to ensure that non-bank private investors have an incentive to invest in CDFIs. There have been some moves to ease the flow of funding from private investors to CDFIs. Community Investment Tax Relief (CITR), which was introduced by the Finance Act 2002, has been devised to stimulate the flow of private finance in the UK's poorest communities via CDFIs. CITR is available to any individual or company with UK tax liability investing in a CDFI for at least five years. The recipient of the relief can offset up to 5 per cent of the amount invested per annum.

The CITR scheme, which is accredited by the Department for Business, Innovation and Skills (BIS), has encouraged greater lending to CDFIs. But despite an increase in private financing, there has been little take-up amongst CDFIs and only 15 CDFI currently possess BIS accreditation. CITR is good in principle but is in need of reform if it is to be a leading vehicle for private investment in CDFIs as the Government first envisaged. Original Government estimates predicted that CITR would raise approximately £200m per annum, but last year it only raised £86m for CDFIs – well short of the Government's hoped for figure.[89]

HM Treasury recently issued a consultation on Social Investment Tax Relief.[90] Part of this considered the future role of CITR and whether there is worth in continuing it as a relief separate from the incoming Social Investment Tax Relief. We not only believe that there is worth in retaining a tax relief specifically aimed at CDFIs, we also believe that there are significant improvements that could be implemented to increase its up-take.

One crucial way in which to improve CITR is to raise the level of tax relief. The current level of 25 per cent over five years does not compare favourably with other tax reliefs (so private investors may choose alternative avenues of investment) and is below what is likely to be set for Social Investment Tax Relief. It is our recommendation that the CITR level should be increased to at least the equivalent of the new social enterprise tax relief once it is introduced. This will make the rate that much more attractive to investors.

Another key amendment to CITR could be to remove the permits CITR to only be utilised for finance provided to SMEs based in disadvantaged communities as defined by the indices of deprivation.[91] Given that only 44 per cent of CDFI corporate lending went to SMEs located in deprived communities,[92] this outdated restriction does not suit the lending activities of CDFIs and hinders their ability to lend to businesses. For this reason is should be removed.

Further, trusts and foundations currently invest £200m in the social finance market,[93] very little of which goes to CDFIs. One key reason for this is that CITR is only deductible from Income Tax and Corporation Tax. This excludes trusts and foundations from utilising CITR and presents a barrier to CDFI investment. We recommend that CITR also be permitted to apply to National Insurance so that some of the large sums of finance that trusts and foundation provide to social enterprises and social finance bodies can be allocated to CDFIs.

We recommend HM Treasury support these reasonable amendments to CITR and introduce these as part of the process that will see-in the introduction of Social Investment Tax Relief. This, we believe, would greatly increase the levels of private finance available to CDFIs and, through them, hard hit communities.

Promoting community finance partnerships

The community finance landscape is dotted with an array of different financing models and organisation types. Alongside CDFIs and credit unions, there are organisations that provide ancillary services in support of financial services, such as advice, consultancy and public service provision. These organisations, which can include social enterprises, community asset organisations or housing associations, perform overlapping functions and often complement each other when delivering services to communities.

What is lacking is an overarching aegis under which these organisations could co-operate on a formal basis. We recommend that Community Finance Partnerships be established to help co-ordinate between community organisations. This would allow CDFIs, credit unions and other community organisations to better compete with larger finance, advice or housing providers through greater resource sharing. This approach would also encourage new approaches to linking finance with social good, as CDFIs and other community finance institutions would have direct, formal links with the social projects that they finance or advise. This would greatly increase the capability of communities and small businesses to meet their financial needs.

To encourage the establishment of Community Finance Partnerships, we recommend that the Government extend the remit of the Credit Union Expansion Project (CUEP) to include a broader range of partner organisations. Currently, CDFIs can form partnerships with credit unions under the CUEP, but this is on an ad hoc basis and mostly excludes other community organisations. This broadening of the CUEP, re-branded as the Community Partnerships and Empowerment Project, would provide the necessary means through which formal and long-lasting partnerships could be developed by community organisations, which would in-turn allow for the provision of more wrap-around community services. However, the current budget of £38m is insufficient to match this additional requirement.

In light of this, we recommend a modest increase in budget size of the CUEP to £73m, which was the original cost of the CUEP prior to a DWP evaluation that focused solely on credit unions.[94] The original funding commitment from the DWP should continue to be allocated as currently planned, but the additional funds should be ring-fenced for partnership building between community finance organisations. Providing a modest increase in funding for the rebranded Community Partnerships and Empowerment Project is a minor investment in relation to the dividends it could provide for financially constrained communities and businesses.

Establishing CDFIs as lenders of 'first resort' for SMEs

As we have been stressing throughout this section of the report, CDFIs provide a vital lifeline to their customers. They are a great alternative to those who lack access to mainstream finance and financial advice. However, under the rules governing Community Investment Tax Relief, CDFIs can only claim this relief if the SME in question has previously been refused finance from a mainstream provider.[95] Given that 38 per cent of SMEs less than five years old have their loans rejected,[96] removing an obstacle for SME applying for finance could obviously be advantageous.

This particular CITR requirement is clearly an impediment to SMEs looking to access finance and presents a barrier to CDFIs wanting to develop relationships with their customers. It cannot have been the intention of HM Treasury in the initial implementation of CITR that CDFIs would be so hindered in providing vital finance to SMEs – indeed this is the sole intention of CITR.

Yet, the situation whereby customers have to be first refused finance by a mainstream provider before CITR comes into effect does amount to an uncompetitive practice. High Street banks are not so constrained when seeking business customers and SME financing would benefit immensely from increased competition.

The CDFA and the British Bankers Association have come to an agreement whereby those customer refused finance by a mainstream bank will be referred by that bank to a local CDFI.[97] This scheme is to be commended. But why wait for the customer to be refused a loan in order to be put in contact with their local CDFIs. We recommend that the Government remove the requirement in the CITR guidance that stipulates that customers must first be refused a loan by a mainstream bank before applying for a loan with CDFIs. With loan rejection rates so high at mainstream banks and many SMEs requiring urgent finance to aid with cashflow problems, making CDFIs lenders of 'first resort' could prove vital for those SME in need of urgent credit.

Opening up the SME lending market in such as way would increase competition amongst lenders, promote diversity amongst financing institutions and insure the market becomes much more responsive to the needs of small businesses.

5. Conclusions and Recommendations

"We instead need an approach to reform that looks at the ability of the financial sector as a whole to fulfil its role as one of society's great economic enablers."

If we are to have a financial sector that is more competitive and diverse, inherently more secure and intrinsically more responsive to the long-term needs of its customers, then we need to adopt an approach to financial reform that looks beyond the individual capabilities of single financial institutions. We instead need an approach to reform that looks at the ability of the financial sector as a whole to fulfil its role as one of society's great economic enablers. This Civic Approach, as we term it, would require policy makers to support those principles and business models that could transform the sector into the model we both describe and propound.

The ten recommendations detailed below are an indication of what steps Government could take to foster such a change.

1. Broaden the scope of financial reform: We believe the current approach to financial reform is too focused on individual institutions and should, instead, be more focused on the capability of the financial sector as a whole to cater to the diverse needs of society. To rectify this, we recommend that the Government undertake a review of its current reform policy to determine how the current suite of reforms could be augmented to factor in the financial sector's wider societal role as an enabler of economic prosperity.

Recommendations for building societies

2. Level the playing field for building societies: The reforms contained within the Banking Reform Act are, for the most part, aimed solely at plc banks. Throughout the reform process, building societies and the valuable role they provide has often been

overlooked. As a result, we believe HM Treasury should establish a 'trigger' policy under which any future reforms to bank policy automatically triggers a review of building society policy to determine if the proposed changes will have negative consequences for the sector, as well as what actions would need to be taken in order to mitigate these negative effects and level the playing field. Under such a policy, it is likely that current capital requirement proposals at the European level would be structured to make them more appropriate for building societies.

3. Encourage building societies to lend more to SMEs: Building societies play a leading role in the personal finance and mortgage market, but are largely absent from the corporate finance market. Loosening the limits under which building societies operate to allow them to lend to hard-up UK SMEs could do much to aid this sector of the British economy. Such a move from Government would in-turn encourage building societies to strengthen their corporate lending skills and adopt a position within the corporate finance market similar to what they hold in the personal finance and mortgage markets.

4. Allow building societies to take over high street banks: The situation whereby building societies can demutualise and be acquired by plc banks, but building societies cannot in turn do the same, creates unfair market conditions and presents significant barriers to the expansion and diversification of the building societies sector. Allowing building societies to take over high street banks, or parts of these banks, in certain circumstances could both increase banking competition and permit building societies to offer a broader range of products to their customers. The floatation of TSB Bank in the summer of 2014 could present such an opportunity. As part of this, the Government should also consider revising the legislation concerning re-mutualisation to streamline the process by which non-mutuals convert to mutual-status. This would have significant advantages with regards attempts to increase banking competition.

Recommendations for mutual societies

5. Release additional capital for mutual societies: Mutual societies play a vital role in the insurance, protection and savings markets. But they are handicapped by existing legislation when attempting to raise additional capital for product and service expansion. In light of this, we recommend that the Government indicate its support for the Mutuals' Redeemable Shares Bill currently making its way through Parliament. Passing this important piece of legislation would help level the playing field with non-mutual insurers with regards capital raising, and would make it easier for mutual societies to expand their range products for the benefit of customers.

6. Help establish networks of mutual societies: By establishing network organisations, mutual societies in Europe and the US are able to compete much more effectively with non-mutual insurers as they are more capable of generating economies of scale. Encouraging mutual societies, which cannot raise capital to the same degree as non-mutuals even with new legislation, to form such networks would greatly increase diversity and competition in the insurance market. We recommend that HM Treasury create an expansion project, very similar to the Credit Union Expansion Project, which enables mutual societies to forge these deep networks and compete more freely with non-mutual insurers.

7. Promote mutual societies to reduce financial exclusion: Financial exclusion is one of society's gravest concerns. Mutual societies already offer financial products to assist those on lower-incomes, but are restrained from expanding in this market further by over-burdensome advice guidelines that mean that financial advice cannot be given to those on lower incomes. We recommend that the FCA, as its role a consumer champion, immediately commence a review of the guidelines detailing 'simplified advice' to determine how an accurate definition could be given that would encourage greater levels of financial advice to those on lower incomes.

Recommendations for community finance institutions

8. Reform the community finance market: CDFIs currently have access to sizeable amounts of public social finance. What they often lack is social finance provided by private individuals and investors. To rectify this, we recommend that all three main political parties commit to introducing a Community Reinvestment Act in the next parliament that will consolidate all existing banking sector requirements on social finance under one heading to streamline the social investment process.

9. Support the development of community finance partnerships: CDFIs and credit unions both provide a valuable role to their customers and their communities. But there does not yet exist a stable means of CDFIs, credit unions and other community organisations from partnering to provide more 'wrap-around' community finance services. We recommend that the budget of the Credit Unions Expansion Project be increased from £38m to the originally envisaged £73m. These additional funds should in turn by set aside for partnership building amongst community organisations to ensure more comprehensive community finance support.

10. Establish CDFIs as lenders of first resort for SMEs: Currently, under Community Investment Tax Relief rules, CDFIs can only offer finance to SMEs if they have first been refused finance by a mainstream provider. We believe this creates an unnecessary barrier to SME looking for much needed finance. As such, we recommend that this requirement of CITR be removed so that SMEs have a much easier path to debt finance.

By shifting to a Civic Approach of financial reform and adopting the above recommendations, we believe that the future financial sector could become one where the needs of customers and communities are given first priority.

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ResPublica Green Papers provide a discussion platform for single exciting ideas in public policy. The purpose of these short, provocative pieces is to outline an argument which could spark a debate and prompt feedback and deeper reflection on the topic. We intend Green Papers to spark debate and more extensive work and research. We hope that this publication does just this.

New Economies, Innovative Markets

This workstream seeks to provide practical solutions for a moral capitalism and sustainable economy. This includes encouraging new market entry, ensuring supply chain resilience through more localised control, promoting greater diversity of business models and facilitating wider asset distribution, in order to achieve an economy based on trust and reciprocity.

Current and forthcoming work will build upon the ideas outlined in our past output which have had a continuing impact on the British policy landscape. Examples of our successes in 2013 include ResPublica's report recommending a new community energy model to unlock investment in local energy projects, and a paper on increasing lending to consumers and SMEs via improvements to risk profiles through protection products. In 2014 this workstream will encompass our research on financial institutions and intermediaries, re-defining economic competition, SMEs and social enterprise, and governance prerogatives for a more responsible form of capitalism.

The Coalition Government has made financial reform an essential part of its legislative programme. Both the financial crisis of 2008 and the resulting recession prompted regulators to adopt a much tougher line on banking regulation. Many of the reforms that have resulted since focus almost entirely on the financial stability of individual institutions. As welcome as these reforms may be, this Green Paper argues that the Government must look beyond the prudential capabilities of single financial institutions.

Instead, this paper argues that the Government must adopt a more holistic approach to reform that assesses the ability of the financial sector as a whole to cater for the needs of society. This approach we call the Civic Approach, as it would require the financial sector to look beyond its own immediate needs and look instead towards the long-term demands of Britain's households, communities and businesses. In short, the sector would need to embrace its civic duty. *Markets for the Many: how civic finance can open up markets and widen access* establishes how such a change in approach could be implemented, as well as how such a move would benefit consumers.

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