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rapid research

Banking on change: Community Reinvestment and re-thinking the UK financial system

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"Despite the immediate and significant challenges and hardship the recession brings, the current situation also provides a once in a generation opportunity to fundamentally re-think how we do things… With bold thinking and a clear vision, the banking sector, which precipitated the current downturn, can in future become a force for sustainable, positive social change."
Toby Blume, Urban Forum, May 2009

INTRODUCTION

In August 2007, investments made by the financial sector that had excessive risks attached to them began to unravel, creating uncertainty and nervousness within the financial system. Banks became apprehensive about lending to each other creating the credit crunch which would eventually lead to a global financial crisis and subsequent recession. The whole financial system had become embroiled in lending and investing inappropriately without assessing the risks that were associated in the chase for bigger profits and this, unsurprisingly, proved to be unsustainable. The nervousness within the economy led to a significant loss of confidence among businesses and consumers.

Financial institutions that had been posting billions of pounds worth of profit just the year before have created a global recession through their excessively risky investment strategies. The Government has been forced to make a significant investment in a number of UK banks and over the past year there has been a growing call to re-think the UK financial system. A new regulatory framework needs to be developed that will not allow a repeat of this situation and to make sure the financial services sector is reformed to engage in corporate social responsibility rather than just paying lip service to it.

The current economic crisis and global recession has identified the need for a more resilient, socially focussed banking system that will weather future shocks. During the last ten years there has been persistent failure of the banking system to meet its social responsibilities and serve the needs of the whole of society or offer financial inclusion for millions of low income households.

Drawing on the body of reports, articles and general commentary that has emerged on the subject, this Rapid Research explores the concept of responsible finance, especially community reinvestment banking, including the growing campaign for a more responsible financial system in the post-recession era and how this might be rolled out in the UK. Responsible finance places obligations upon banks and other financial institutions to be socially conscious in providing credit and banking services to lower income individuals and to provide benefits to local communities and small businesses.

This Rapid Research has been produced by the Centre for Local Economic Strategies (CLES) in partnership with Urban Forum, a national charity and membership organisation that supports communities to have a greater say over decisions that affect them. The pursuit of a fairer banking system is a major campaign of Urban Forum which CLES fully supports. Strengthening the financial sectors corporate social responsibilities and therefore creating a new approach to finance by making sure all sections of the community are treated fairly in terms of access to financial products will help to create more resilient and equitable communities in the future. This publication analyses existing evidence to support both change per se and introduction of responsible finance principles to the UK financial system. It concludes that firstly, change is essential for overcoming persistent financial exclusion and secondly, that community reinvestment offers a beneficial way forward for the UK *but* is a long term option that needs to be supplemented in the shorter and medium terms by other options for socially responsible banking.

THE PROBLEMS WITH THE CURRENT FINANCIAL SYSTEM

It has become increasingly clear there are serious systemic faults with the current financial services sector, not only demonstrated by their collapse that led to recession and a consequent erosion of public confidence in banks, but also in their longer term inability to deliver financial and social inclusion for lower income households. There are a number of substantiated arguments for rethinking the pre-recession status quo and developing a new way of banking that promotes financial inclusion and greater public satisfaction. These arguments centre upon overcoming the failures that we are seeing today, which firstly need to be understood if we are to get a clearer idea of what a preferred system might look like and what it would need to achieve in the post-recession era. This section sets out the major failures of the current financial system.

Financial exclusion of low income individuals and households

Financial exclusion of lower income individuals and households is arguably one of the most serious failures of the modern banking system, and is closely linked with economic and social exclusion. The poorest people are excluded from access to reasonably priced credit and bank accounts, leading to high levels of debt obtained from both regulated and unregulated loan companies, with higher rates of interest attached. This is part of an overall 'poverty premium' that low income households pay for basic utilities and banking services. For example:

- 2.1 million people living in 1.4 million households do not have access to a bank account of any kind[1];
- the poorest in society spend around 4 times more of their money repaying loans than affluent people[2];
- there are approximately 165,000 users of illegal money lenders in the UK[3].

In 2007, Save the Children and the Family Welfare Association[4] calculated this poverty premium to be around £1,000 per year, including 150% more for basic goods such as an oven bought on credit; 10% more on gas bills and 8% more on electricity bills paid through pre-payment meters rather than by

[1] Family Resources Survey United Kingdom 2006/07. DWP, 2008
http://research.dwp.gov.uk/asd/frs/reports/
[2] Bank of England's 2006 NMG survey
[3] Research for BERR (now Department for Business Innovation & Skills) - PFRC and Policis (2006)
[4] Save the Children and the Family Welfare Association Research (2007)

direct debit; and greater home and car insurance in deprived areas.[5] Some of the most worrying and worsening symptoms of the current financial system experienced by lower income households are set out below.

Inability to set up a bank account

Nearly one in 12 households does not have a bank account. This leads to multiple disadvantages in terms of paying bills, accessing employment and receiving state benefits, all of which require a bank account in the vast majority of cases. Reasons behind this inability to get a bank account include difficulties experienced by some low income and highly mobile groups in proving their address (which is also a barrier to employment in its own right). Addresses may be difficult to prove, for example:

- for those who do not have utility bills (they pay through a meter, and pay more at that);
- for those who receive Council Tax Benefit (i.e. a reprieve of Council Tax so that no bills are sent to them);
- for those who do not live in what is deemed as stable and permanent accommodation (e.g. people who have been classified as homeless following home repossession or suffering domestic violence, and placed in emergency or temporary accommodation such as local authority hostels, B&Bs or refuges).

As well as an inability to set up a bank account because of difficulty in proving an address, there may be geographical barriers as banks are increasingly removing their branches from deprived communities and peripheral locations, and perception barriers – 'banks won't let *me* set up a bank account'.

Access to fair terms of credit

The lack of available and affordable credit from banks and the increasing prevalence of serious debt problems has led to an increase in people's risk of turning to illegal lenders – 'loan sharks' – for unregulated, high interest loans. A report published by the New Local Government Network (NLGN) in May 2009, estimated that 200,000 people across Britain are at real risk of using loan sharks during the recession, of which at least 35,000 will actually do so.[6] This was attributed to a combination of reasons, including the reduction in sub-prime lending, often known as 'door-step lending'. Door-step lending in itself is an undesirable avenue towards accessing credit; although lenders are regulated, they charge very high levels of interest and make up the bulk of predatory lending. For example, Provident Financial, Britain's largest doorstep lender, recently announced profits of £53.1m for the first half of this year as the recession has deepened and affected an increasing number of households.[7] The industry as a whole however has not done as well as Provident Financial, with Cattles, a UK based sub-prime lender having to axe 1,000 jobs across the UK as it struggles to survive the financial crisis. Cattles had been reliant on borrowing from banks to underpin its lending operations[8].

As the number of players in the sub-prime market shrinks this could push more desperate customers towards loan sharks. Although doorstep lenders charge high levels of interest they are the only option in accessing credit, albeit at an unfair interest rate, available to many people. Also, the economic downturn, including rising prices, considerable job losses and an increase in the number of loan refusals by the Government's emergency Social Fund from 316,000 to 596,000 since the recession began, have contributed to the rise in loan shark use.

The real problem therefore, is the lack of a responsible credit law to provide alternative options on the supply side that offer a fairer deal than the current bleak options faced by many lower income households. The NLGN report calls for local authorities to place greater resources into local credit unions or council banks, and to map out predatory lending and enhance enforcement against loan

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[5] See the authors' briefing on this report at http://www.savethechildren.org.uk/en/docs/poverty_briefing.pdf

[6] *Circling the Loan Sharks: Predatory lending in the recession and the emerging role for local government*, NLGN, May 2009. Available at http://www.nlgn.org.uk/public/wp-content/uploads/circling-the-loan-sharks.pdf. This figure of 200,000 people was extrapolated from earlier BERR research that estimated 160,000 people were at risk

[7] See http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6731180.ece

[8] Doorstep lender Cattles sheds 1,000 Jobs, Guardian. January 2009. http://www.guardian.co.uk/business/2009/jan/07/cattles-creditcrunch

sharks. These calls echo the earlier report by McCartney and Gibbons released in December 2008,[9] that found that low wage families are increasingly experiencing 'credit dependency' on high cost and predatory lenders. Recent years have seen a significant growth of the sub-prime industry that specialises in providing extremely high cost credit products to low income groups. For example:[10]

- home credit – door to door collection loans which charge between 180%-1500% APR depending on the length of the loan;
- payday lending – takes post dated cheques as security for loans of up to a month in duration and routinely charges in excess of 1000% APR. One internet based payday lender advertised rates at over 9000% APR;
- auto-title loans – takes car log books as security and typically charge between 370%-430% APR for loans over a period of 12-18 months.

The cost of credit options available to lower income households is a significant problem in trying to tackle financial deprivation, and has drawn attention to the fact the credit markets have not been operating effectively. The recommendations from McCartney and Gibbons were that that the Government need to increase access to responsible credit products from mainstream financial institutions and take firmer action against predatory lending.

Overcoming financial exclusion

Making the link between economic and social exclusion, the Joseph Rowntree Foundation published a review of initiatives to tackle financial exclusion in the UK.[11] They concluded that financial exclusion in the majority of cases is caused by a complex set of mutually reinforcing factors. These include geographical exclusion e.g. resulting from branch closures, lack of ATMs in poorer areas; failure to qualify for credit because of poor credit history or problems in supplying identity document requirements; the relative cost of financial products and services e.g. high interest rates, charges for unauthorised overdrafts; and cultural and psychological barriers. Therefore, the report argues that initiatives to overcome financial exclusion will need to overcome *all* of these considerations. Thus a holistic approach to rethinking banking will provide the most successful and sustainable solutions, and this is offered by responsible finance and associated legislation that would underpin the financial services regulatory framework.

WHAT IS COMMUNITY REINVESTMENT?

The premise behind community reinvestment is that obligations are placed upon banks and other financial institutions, through legislation, to consider the needs of low income households and small businesses and make banks active contributors to sustainable, positive social change.

The basic argument for some kind of community reinvestment legislation is that if society, via Government, effectively underwrites systemic risks in the financial markets then those financial institutions engaging directly with the general public (banks, insurance companies, investment managers such as pension funds) have a duty to ensure that the whole of society is able to access their services.

A good definition of community reinvestment legislation, from the Development Trusts Association (DTA) is that which:

[9] *Protecting Low Income Borrowers in the Credit Crisis*, Rt. Hon. Ian McCartney MP and Damon Gibbons (Centre for Economic and Social Inclusion), 2008. Available at http://www.debt-on-our-doorstep.com/files/Protecting%20low%20income%20borrowers%20in%20the%20credit%20crisis.pdf

[10] Ibid., p.8

[11] *Financial exclusion in the UK: Review of policy and practice*, Lavinia Mitton, JRF, July 2009. Available at http://www.jrf.org.uk/publications/financial-inclusion-uk-review-policy-and-practice

"ensures that financial organisations must engage with, design services for, and invest in people and businesses in poor neighbourhoods, least able to withstand the consequences of financial market failures in other parts of a system, over which they have no stake or control".[12]

The DTA paper, one of many recent calls to implement a UK version of the USA's Community Reinvestment Act (explored later in this report), then goes on to describe community reinvestment legislation as:[13]

- an ethical responsibility due to the centrality of the financial markets to the economy;
- a geographically targeted obligation on financial institutions;
- based on a wide requirement to disclose information by the financial institutions;
- more than just about money.

To date, community-focused financial organisations such as Community Development Finance Institutions (CDFIs) and credit unions, have been established in areas where there is limited access to finance due to the failure of mainstream banking to deliver financial inclusion. However, the introduction of community reinvestment legislation would achieve a system where all banks have to support social and community enterprises and cannot discriminate against low income households through unaffordable prices of credit, refusal to grant bank accounts, branch closures, unfair eligibility conditions on mortgages for low cost housing, and other exclusionary practices. Such legislation would mean therefore that, rather than being found in just a small number of third sector organisations, community reinvestment principles would be intrinsic to the whole system of banking in UK, providing the critical mass necessary for sustained social and economic change. This would also remove any competitive advantage experienced by some banks that continue the drive for profits and do not take their social responsibilities seriously.

Community reinvestment banking

A total of £141.3 billion[14] has been used by the Government to prevent a number of commercial banks from collapsing, including Northern Rock, Bradford and Bingley, Lloyds TSB, HBOS and Royal Bank of Scotland. This huge sum has come both from taxpayers' money and through incurring national debt that will have to be paid off for decades to come. It is important that citizens gain public benefit from this use of public money and that some economic and social benefits are salvaged from the situation. Urban Forum argue that, as the Government has provided an 'insurance policy' by bailing out the banks with public money, taxpayers should receive an 'insurance premium' by way of social benefits.[15] In other words, it is the responsibility of the banks, many of whom have been recapitalised by the Government, to now act to recapitalise small businesses and low income households who are struggling in the economic downturn and who were financially excluded even in times of economic prosperity.

Community reinvestment banking would provide this answer by creating a system where banks are still run as commercially viable businesses, yet they provide financial services without discrimination. A proportion of profits from the banks are reinvested into supporting community action that is of public benefit through providing grants. This offers a secure opportunity for savers and investors as well as a sustainable income stream to support community organisations, self help groups, charities and social enterprises. This will enable the third sector to respond better to local needs, aiding recovery from recession in the short/medium term and building a healthy civil society for the future. Committed to citizen engagement and transparency under a community reinvestment system, allocation of resources from banks could be decided by a panel of representatives from the banks, local government and community groups. This would add value to local partnership working, particularly in LSPs, by developing relationships and building trust.

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[12] *Time to re-visit a Community Reinvestment Act for United Kingdom financial institutions*, Hugh Rolo, Development Trusts Association, 2009, p.1
[13] Ibid. p.1-2
[14] As of end of June 2009. *Statistical Bulletin: Public sector finances*, ONS, July 2009. Available at http://www.statistics.gov.uk/pdfdir/psf0809.pdf
[15] See http://www.urbanforum.org.uk/briefings/10-things-you-need-to-know-about-community-reinvestment

While there are concerns that taking this approach will make banks vulnerable by giving credit to more risky customers that have lower incomes and possibly weaker credit ratings, no permanent address and a perceived greater chance of defaulting on their loans, there is no proof that this is necessarily true. It has been proven that people on low incomes can be given credit at fair prices and do not have higher rates of defaulting than those on higher incomes. Contrarily, lending at lower prices reduces the risk of defaulting – a concept that banks currently seem not to appreciate. CDFIs and credit unions (see appendix) have been lending money to low income households and individuals for a long time, and have not seen higher rates of defaulting than commercial banks. While the sector has had some problems with both the Dunfermline and West Bromwich building societies collapsing, the losses at cooperatives or ethical finance institutions have been far smaller than the non-ethical ones. Microfinance schemes such as the Grameen Bank, have also been implemented successfully to provide small yet life-changing amounts of finance to the poorest people, spreading risk across a cohort of lenders or community. Formed and based in Bangladesh, the Grameen Bank has been rolled out in China, Zimbabwe, New York City and is planned for Glasgow. With the average loan being $220 (a sum deemed too little to be worthwhile for conventional banks to loan and offered to perceived high risk people), repayments rates are nearly 100%. Community finance therefore, can work.

Community reinvestment proposals

Urban Forum have been working on community reinvestment banking with partners, and have developed four specific proposals, that when combined, will provide the necessary changes to the way financial services are regulated to support, rather than hinder, efforts to tackle the causes of inequality and poverty.

1. **Support for communities: banks be required to re-invest at least 1% of profits to support public benefit**

   Banks and financial institutions have made enormous profits over recent years and are quickly recovering from the banking crisis to post large profits once again. In return for the insurance that the government (and taxpayers) provided to the banking system, responsible finance means reinvesting profits to support activity that is of public benefit. Financial institutions should be required to re-invest 1% of their profits back into communities in the form of grants. Local or regional panels made up of people from the banks, the third sector and local government should be established to make decisions about the allocation of this money in the form of grants.

2. **Responsible credit: making it illegal for lenders to charge as much as they like for loans**

   In many deprived areas the need to borrow money means a choice between a payday lender charging 300% interest or a loan shark charging 3000%. It should not be legal for predatory lenders to charge whatever rate of interest they want to. A responsible credit cap should be introduced to fix an upper legal limit for the amount of interest that can be charged for a loan.

3. **Disclosure: banks must publish information to demonstrate they are serving the needs of all communities, without discrimination**

   Money flows into financial institutions, even from poor communities – for example all the housing benefit and Job Seekers Allowance that go into bank accounts. However there is little evidence that money and banking services[16] are equally available to deprived communities – many poorer neighbourhoods have no access to an ATM and are regularly charged more for the same service as affluent customers. Banks and financial institutions should be required to publish information on where their money comes from and where it goes to by neighbourhood[17]. Disclosure would also require information to be published on how services are provided to different groups - for example women, ethnic minorities and disabled people. Disclosure is the foundation for responsible finance because without access to this information it is impossible to properly (and responsibly) address discrimination that exists in how financial services are provided.

[16] Services include loans and savings and banking facilities (like having branches, business support or an ATM)
[17] Neighbourhood, in this instance means 'Super Output Area' (SOA), the smallest area for which data is routinely collected by the Office of National Statistics.

4. **Investment – banks must take steps to eliminate any discrimination in how they provide financial services through a Community Reinvestment Act**
   Responsible financial institutions have a duty to meet the needs of all communities and any discrimination that is identified through disclosure will need to be addressed. This means access to banking facilities (an ATM, for example) as well as fair access to loans and investment for individuals and organisations. Through community reinvestment legislation (along the lines of the US Community Reinvestment Act) financial institutions will be required to ensure their services are equally available to all communities and groups. Banks can meet their responsibilities either directly, for example opening a branch or banking facilities in a deprived area, or through an intermediary, by investing in a Community Development Finance Institution or a local credit union.

THE COMMUNITY REINVESTMENT ACT

The US Community Reinvestment Act

The Community Reinvestment Act (CRA) was the fourth in a series of laws which were created to develop a robust regulatory framework that collectively focused on combating discrimination in housing and the extension of credit on the basis of race, colour, religion, sex or national origin. With consistent pressure and determination, Civil Rights and community groups have used the CRA to stem disinvestment and redlining in minority communities as well as to partner with banks to increase the level of home ownership in those communities[18].

The CRA was passed in 1977 and sought to address discrimination in loans made to individuals and businesses from different areas or neighbourhoods. The Act however, has no disciplinary powers to fine banks for not adopting social inclusion policies. Compliance is instead monitored and financial institutions are evaluated on their performance. In 1995, the Clinton administration gave the CRA some additional powers by prohibiting mergers or takeovers involving financial institutions that had poor CRA compliance. This provided real incentives for financial organisations to achieve 'good' ratings, providing corporate flexibility which meant financial savings, for example from very complex and expensive legal fees.

The CRA is a geographically targeted obligation on financial institutions. The Act requires the appropriate regulator (there are different regulators for different sizes and types of banks, e.g. the Office of the Controller of Currency (OCC)) to assess a national bank's record of helping to meet the credit needs of its entire community, including low- and moderate-income neighbourhoods, consistent with safe and sound operations. It also mandates that the agency consider that record in its evaluation of a bank's application for new branches or relocation of an existing branch, bank mergers and consolidations, and other corporate activities.

The CRA's implementation regulation (which is proportionate and reflects the different types and sizes of banks) requires the OCC to rate a bank's service performance 'outstanding' if, in general, the bank demonstrates:[19]

- its service delivery systems are readily accessible to geographies and individuals of different income levels in its assessment area(s);
- its record of opening and closing branches has improved the accessibility of its delivery systems, particularly in low- or moderate-income geographies or to low- or moderate-income individuals;
- its services (including, where appropriate, business hours) are tailored to the convenience and needs of its assessment area(s), particularly low- or moderate-income geographies or low- or moderate-income individuals;
- it is a leader in supporting housing and asset development services.

[18] Building Healthy Communities: The Community re-investment act and the financial modernisation movement – Civilrights.org http://www.civilrights.org/publications/healthy_communities/
[19] *Office of the Comptroller of the Currency – Community reinvestment act information*, 2009. Available at http://www.occ.treas.gov/crainfo.htm

In theory this should lead to wider good practice, for example:[20]

J P Morgan Chase mission statement

Our mission is to strengthen communities in which J P Morgan Chase & Co. does business by:

- Expanding access to capital
- Leadership by example
- Leveraging the many resources of J P Morgan Chase

Central to this mission is serving:

- Low- and moderate-income communities
- Small businesses (particularly minority- and women-owned)
- Low-to-moderate-income individuals and families

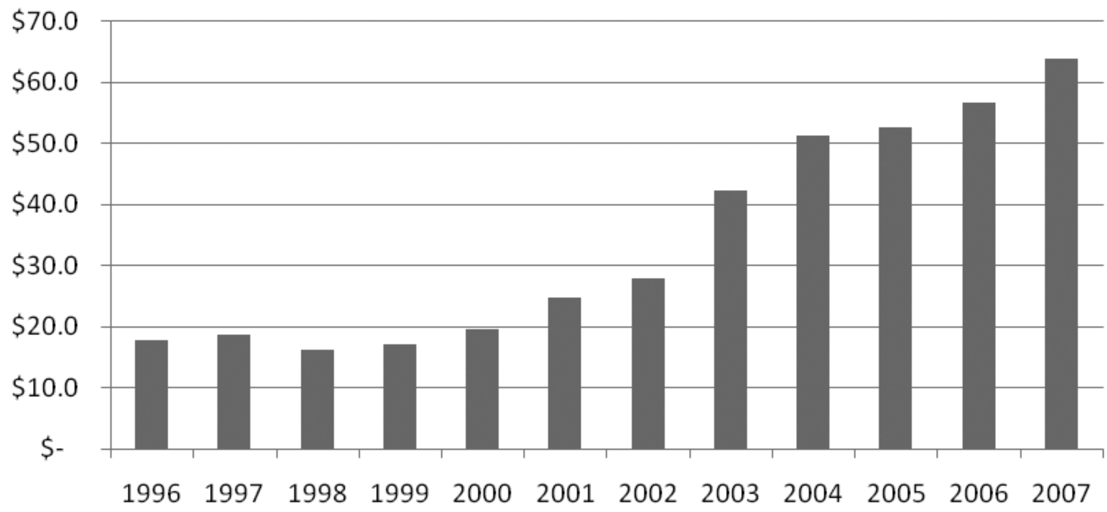
We help through services such as:

- Credit
- Banking
- Mortgages
- Technical assistance
- Advisory services to community groups and non-profit institutions serving these communities

We also provide philanthropic support to non-profit organizations located in the communities we serve.

The CRA is, therefore, more than just about money. It is about making sure that the poorest communities have fair and equal access to the benefits of modern financial services so that they are not disadvantaged by financial exclusion and higher costs of living.

Total CRA Community Development Lending 1996 – 2007[21]



[20] J P Morgan Chase mission statement. Available at http://www.jpmorganchase.com/cm/cs?pagename=Chase/Href&urlname=jpmc/community/cdg

[21] *FFIEC CRA National Aggregate Report Table 3 (http://www.ffiec.gov/craadweb/national.aspx)*

The sub-prime crisis and the CRA

An emerging body of commentary in the US has discussed whether the CRA was one of the main causes of the sub-prime housing crisis which acted as the catalyst for the global downturn. At the start of the crisis, critics suggested that encouraging banks to lend to disadvantaged communities led to more unsuitable loans being sanctioned; therefore it was inevitable there would be a rise in the default of mortgages and loans.

Few experts or industry professionals agree that CRA-motivated loans to low- and moderate-income households led to the near-collapse of the US mortgage lending industry. The CRA, and the implementing regulation, was developed so *regulated* financial institutions (defined elsewhere in the code as federally insured, deposit-taking national and state chartered banks and savings banks) have a positive obligation to extend credit services in the communities in which they are chartered.

As the mortgage industry grew, a number of new participants entered the market. The sheer volume of business forever changed the way mortgages were funded. Traditional savings and certificate of deposit sources were supplemented with the consolidating, pooling and packaging of loans to be sold to investors on the secondary market. Long-entrenched government-sponsored entities, including Ginnie Mae, Fannie Mae and Freddie Mac, were joined by an ever-increasing number of private Wall Street investment banks and private issuers of mortgage-backed securities.

Thanks to increasingly sophisticated and inexpensive technology, regulated banks were no longer the primary originators or funders for these secondary market loans. Instead, a large portion of the funding came from non-traditional sources (such as Wall Street firms including the now bankrupt Lehman Brothers and Merrill Lynch), non-bank mortgage banking and mortgage broker operations (ranging from giants like Countrywide Financial Corporation to small shops and individuals), who rapidly increased their market share of loan originations. None of these investors fell under the CRA remit.[22]

It is more likely that it was these financial institutions that did not fall under the CRA remit that provided the more risky loans to sub-prime customers, for example Lehman Brothers went bankrupt through their exposure to sub-prime mortgage loans. Research cited by former Federal Reserve Governor Randall Kroszner[23] showed that 60% of higher priced, sub-prime loan originations went to middle or higher income borrowers or neighbourhoods. Such borrowers were not the populations targeted by the CRA. In addition, more than 20% of the higher priced sub-prime loans were extended to lower income borrowers or borrowers in lower income areas by independent non-bank institutions, which were not covered by the CRA. Earlier research by the Federal Reserve on sub-prime loans originated in 2005-2006, showed that CRA-related loans in low- and moderate-income neighbourhoods performed comparably with other sub-prime loans. It was also noted that in fact most repossessions between January 2006 and August 2008 occurred in middle-upper-income neighbourhoods, and that these have increased at a faster rate than for low- to moderate-income neighbourhoods.

Research by the Federal Reserve's of Boston and San Francisco on lending in California[24] looked at differences in sub-prime lending between CRA lenders and independent mortgage companies, which are not subject to CRA exams or compliance requirements. One of the key findings was that while CRA lenders generate more loans in low- and moderate-income neighbourhoods, independent mortgage companies originated a much greater share of sub-prime loans in low- and moderate-income neighbourhoods compared with CRA lenders. In low income neighbourhoods, independent mortgage companies' share was 52.4%, compared with 29% for CRA lenders.

[22] *Compliance: Community Reinvestment Act of 1977*, Kevin Kane and Lorraine Woos, May 2009. Available at http://www.thefreelibrary.com/Is+CRA+responsible+for+the+meltdown%3F+Did+the+Community+Reinvestment...-a0200451969

[23] *The Community Reinvestment Act and the recent mortgage crisis*, Governor Randall S. Kroszner, December 2008. Available at http://www.federalreserve.gov/newsevents/speech/kroszner20081203a.htm

[24] *Revisiting the CRA: Perspectives on the future of the Community Reinvestment Act*, Federal Reserve Banks of Boston and San Francisco, February 2009. Available at http://www.bos.frb.org/commdev/cra/Revisiting-the-CRA.htm

OPTIONS FOR THE UK

The Labour Government has tried to deal with the issue of financial exclusion and has launched a number of initiatives aimed at tackling the problem. In 1999, working with banks, the Government recommended the creation of basic bank accounts[25] to tackle the problem of nearly 3 million adults not having access to this type of service. In 2004 the Government released their first financial inclusion strategy,[26] announcing a shared goal with banks of halving the 2.8 million adults living in 1.8 million households without access to a bank account. This was followed up by a new financial inclusion action plan for 2008–11 which outlined how Government will use the £130 million Financial Inclusion Fund announced in the Comprehensive Spending Review.[27]

The Government has also tried to strengthen the Financial Services Authority through primary legislation (Financial Services and Markets Act 2000) to give the agency more powerful statutory objectives including financial inclusion. Even with all these initiatives in place it is obvious Government legislation has failed to encourage the big retail banks to carry out their voluntary obligations to tackle financial exclusion under the Banking Code.[28]

However these initiatives have not done enough. The financial crisis has meant the government now owns all of Northern Rock, 43% of Lloyds-HBOS, 70.33% of RBS and Bradford and Bingley (the government nationalised the mortgage arm of Bradford & Bingley, while its deposits and branch network were sold to Santander) at a cost of £141.3 billion to the taxpayer. This has put bank reform firmly on the political agenda and gives the government a unique opportunity to really tackle the failings of the current system and consider new and innovative ideas to make sure financial services are available to all.

A UK Community Reinvestment Act

There is a growing call[29] for the UK government to look at the example of the Community Reinvestment Act from the US and develop a similar piece of legislation for the UK to make sure that banks fulfil their social responsibilities. The lack of financial infrastructure within disadvantaged communities that the CRA was developed to address in the US is a problem that needs to be dealt with in the UK. There has been a decline in the local lending infrastructure and the lack of bank branches. There are only 170 branches per million people in the UK compared to 520 in Germany and 960 in France. The number of bank branches is also decreasing all the time, particularly in low income areas.[30] Recent Treasury research also showed that 1,701 areas within the most deprived quartile have no free cash machine or access to one within a kilometre.[31] The Financial Inclusion Taskforce recognised that, while the government had not forgotten the financially excluded, the problem is that progress is too slow. Initiatives like the basic bank accounts have not proven to be the solution to the problem and there is a need for new, innovative ideas to be considered.

Now is a highly opportune time for the Government to seriously consider introducing a Community Reinvestment Act for the UK. This agenda has been gathering pace and voices for some time, including the Treasury's Social Investment Taskforce, who called for financial disclosure and a UK CRA some years ago, along with a Social Investment Bank. The duel situation of recession and long term

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[25] *Access to financial services, report of PAT 14,* HM Treasury, November 1999. Available at http://www.hm-treasury.gov.uk/press_190_99.htm

[26] *Promoting financial inclusion,* HM Treasury, December 2004. Available at http://www.hm-treasury.gov.uk/d/pbr04_profininc_complete_394.pdf

[27] *Financial inclusion action plan for 2008-11*, HM Treasury, December 2007. Available at http://www.hm-treasury.gov.uk/fin_inclusion_actionplan08_11.htm

[28] *In Brief: financial exclusion*, Transact and Resolution Foundation, 2008. Available at www.transact.org.uk/core/core_picker/download.asp?id=272

[29] See http://www.urbanforum.org.uk/supporters/supporters

[30] *Delivering the Post Bank*, Post Bank Coalition, 2009. Available at http://www.neweconomics.org.uk/NEF070625/NEF_Registration070625add.aspx?returnurl=/gen/uploads/4xf3ow4554jhnv455hd4y5nf14072009113218.pdf

[31] Based on analysis of the Index of Multiple Deprivation; see *Cash machines – meeting consumers needs*, Report of the ATM Working Group, HM Treasury, 2006 http://www.hm-treasury.gov.uk/d/atm_working_group_final.pdf

financial exclusion now makes this a crucial time for new ideas and bold decision-making. The Government could use the US CRA as a baseline model and adapt and develop it, taking into account the new thinking and ideas that have come from the US (see below). A framework could be developed that takes the US CRA one step further and ensures financial exclusion is tackled successfully in the UK context.

Reasons for the Government to look at developing a UK CRA include:[32]

- as part of the required wider regulatory reform, a 'price' to rebuild trust in financial institutions;
- it would provide a firmer piece of legislation to make sure banks achieve their obligations in targeting and serving deprived communities;
- large UK and foreign financial institutions already have compliance expertise through their US operations;
- there would be a substantive contribution to redressing the costs of financial exclusion and local deprivation;
- 'qualifying activities' could be tailored to underpin a range of existing UK policy initiatives: recent DWP initiatives around financial inclusion, targeted deprivation funding, Community Development Finance Institutions and pro bono engagement;
- this chimes with the general call for greater transparency and simplicity in the financial markets;
- costs of compliance would be much less in a more consolidated UK domestic financial market;
- this legislation should get cross-Party support;
- it would satisfy the growing interest in Corporate Social Responsibility within the corporate sector.

Learning from the US CRA

A UK version of the CRA should learn from the past experience of the US and also their present thinking on how the CRA might be amended and improved for the future. Currently, the US is utilising the impetus of the recession to re-examine how the CRA can be reinforced. This is an opportunity to strengthen its powers to prevent another mortgage crisis from happening. Ideas include:

- Expanding CRA coverage to all types of financial companies. Given that the motivation for the CRA in America, i.e. CRA compliance in exchange for federal deposit insurance has been challenged by recent events with unprecedented use of taxpayer dollars to fund bailouts for all sorts of financial companies, this might suggest that the CRA's reach should likewise be expanded. Independent mortgage companies, insurance companies, credit unions and broker-dealers, among others, should be subject to CRA compliance and help fund CRA-type initiatives such as affordable housing in exchange for the financial benefits they reap directly or indirectly from government involvement and support.

- Using expanded CRA coverage to broaden fair-lending supervision and enforcement. This would narrow the fair-lending gap meaning a better deal for all levels of borrower and also level the playing field between different types of lenders with respect to industry practices and regulatory burden.

- Conducting a detailed review of the regulations that are needed to implement the CRA. It has been highlighted there is a need to re-evaluate CRA compliance rules to improve their applicability to today's economic environment.

- Revisiting the CRA scoring mechanism to achieve better balance between the service test and the lending and investment tests. Given issues such as minority market failure, increasingly problematic under-banked areas and the now near-crisis need for financial education as well as basic banking and social service support for low- to moderate-income families, some commentators are suggesting a revisit of the CRA scoring system to train and support banks in

[32] *Community Re-investment Act*, Development Trust Association, 2009. Available at http://www.dta.org.uk/activities/campaigns/otherpolicychannel/cra.htm

continuing their engagement with disadvantaged communities during this time of constrained lending opportunities[33]

CONCLUSIONS

The near collapse of some of the UK's biggest banks has exposed the serious flaws that exist in the current financial system. In the past, banks have enjoyed billions of pounds of profits while seemingly ignoring their voluntary obligations to tackle financial exclusion. To build even bigger profits, financial infrastructure that served communities like bank branches and free cash machines have been withdrawn. There is an urgent need to tackle the level of financial exclusion which continues to undermine efforts to regenerate deprived communities. The global financial crisis has raised fundamental questions about the sort of society and institutions we want in the future and offers a chance to fundamentally change things for the better.

Taking the opportunity

The huge amount of public money put into banks to prevent them from collapsing has so far offered very little obvious benefit to citizens and communities. This Rapid Research has shown that there is a real need for the Government to act to remove the social weaknesses of the banking sector by ensuring 'public money' works for 'public benefit' through establishing a new model of people-centred finance, fit for the evolving 21st century economy.

Urban Forum have provided the lead in this area and their four proposals will provide the necessary changes to financial services so that they are regulated to support, rather than hinder, efforts to tackle the causes of inequality and poverty:

- banks must take the step to eliminate any discrimination in how they provide financial services by engaging with a UK Community Reinvestment Act;
- banks must publish information to demonstrate they are servicing the needs of all communities without discrimination;
- it should be made illegal for lenders to charge as much as they like for loans;
- banks should be required to re-invest at least 1% of profits to support public benefit.

The introduction of responsible finance legislation would be a useful first step to start reshaping the system. Research from the US has shown that it was the financial institutions that did not fall under the CRA remit that lent excessively and dangerously to the sub-prime market that eventually collapsed. The UK should use the US CRA as a starting point and integrate new thinking and ideas so that UK legislation covers all financial institutions and types of loan and has the powers to make a difference.

Long term and short term possibilities

Although the potential changes mentioned in this paper provide socially and economically inclusive next steps to put right the way the current financial structure operates, it will need strong leadership by the Government to come to fruition. New legislation like a UK CRA is likely to come up against strong resistance from the financial services sector, as was the case in the US when the CRA was first proposed. Whichever Party wins power at the next general election will be mindful that the professional services have in the past been the biggest generator of wealth in this country and a major employer, and therefore will seek to find favour within this sector.

While the good fight is being taken to Westminster, there are mechanisms and initiatives that should be strengthened in the short term to mitigate some of the problems brought about by financial exclusion. Concepts such as credit unions, CDFIs and microcredit already exist and are tackling the problems CRA legislation would be forcing the national banks to face up to. In the short term the

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[33] *Revisiting the CRA: Perspectives on the future of the Community Reinvestment Act*, Federal Reserve Banks of Boston and San Francisco, February 2009. Available at http://www.bos.frb.org/commdev/cra/Revisiting-the-CRA.htm

Government should be exploring how to best utilise the existing ethical financial infrastructure and help the different institutions to collaborate, thus providing a real alternative to the current system.

Final thoughts

CLES fully supports Urban Forum on this agenda. There is a real need to continue trying to influence Government policy on this and not miss the opportunity that the recession has provided to achieve a real transformation of the financial sector to make sure it adequately caters to all members of society. CLES believes tackling financial exclusion through a UK Community Reinvestment Act would play a crucial role in helping communities to become more resilient and therefore create a stronger fairer economy in the future.

A convincing argument has emerged, asserting that a positive change to deliver better economic and social outcomes can be achieved through a Community Reinvestment Act for the UK. A minor change in a minor proportion of the banking sector (i.e. the socially focused banking infrastructure) will not overcome the deep-rooted failures of the UK financial system, and public confidence (and political popularity) could be regained through the opportunity of community reinvestment legislation.

APPENDIX

Community Development Finance Institutions (CDFIs)

Community Development Finance Institutions (CDFIs) are a financial tool for social, economic and physical renewal in under-invested communities. They lend and invest in deprived areas and underserved markets that cannot access mainstream finance. They are sustainable, independent organisations that provide financial services with two aims: to generate social and financial returns.

Community development finance is a relatively new sector in the UK. Recent figures for CDFI's in the UK show that this sector is showing strong growth[34], reporting that:

- CDFIs continue to serve markets that have difficulty accessing finance, including start-up businesses, female and BME businesses, and individuals on low incomes;
- investment and loan portfolios grew by 15.3% to £331m in 2008;
- 35% of CDFIs are operating with fund sizes of £1m-3m;
- CDFIs have reported 9.2% growth in income from fees, portfolios and funds under management between 2007 and 2008;
- CDFI lending totalled £76m in 2007/08, levering in a further £35m of additional finance into underserved markets.

Credit Unions

Credit unions are not a new phenomenon. Around the world, there are 172 million members in 46,000 credit unions operating in 97 countries. In the USA, Canada and Australia, over a quarter of the population belong to a credit union.

A credit union is a financial co-operative which provides savings, loans and a range of services to its members and is owned by its members. Each member has one vote, no matter how much they have invested and volunteer directors are elected from the membership. The ethos behind credit unions is that they enable communities to help themselves. Membership of a credit union is based on a common bond; this can be living or working in a certain geographical area, working for a particular employer or in a particular industry. Some common bonds cover villages or towns, while others cover entire cities or regions.

[34] *Inside out 2008 – The state of community development finance*, Community Development Finance Association, 2008. Available at http://www.cdfa.org.uk/cmframe.php?prmid=1200

Credit unions within the UK are well placed to engage with the most deprived communities and tackle financial exclusion which has been identified as one of the most important aspects of a cycle of deprivation. Credit unions can provide a community owned and a community based solution by providing a social framework to compliment the financial one. The infrastructure they have already developed in some of the most disadvantaged areas means they also provide a way of ensuring money is kept within the local community.

One of the key objectives of a credit union, set out in the 1979 Credit Unions Act, was to assist in the education of their members in the wise use of money. Credit unions can potentially play a valuable role in equipping people to be effective and responsible users of financial services.

Another key strength of credit unions is that they can tackle financial exclusion by primarily using a community's savings to provide a low-cost line of credit. Residents that live in more disadvantaged areas and are classed as sub-prime customers are often targeted by doorstep lenders and loan sharks who are known to charge a high premium for the money they lend. Home credit companies could charge up to £130 to borrow £200 over a period of 6 months. The same loan from a credit union would cost no more than £14.23 in interest, and could cost less than this.[35] The low-cost credit supplied by Credit Unions is particularly valuable for those who have difficulty borrowing at an affordable rate from mainstream financial providers and might otherwise turn to loan sharks.

It has already been discussed that the financially excluded pay an additional price for their utilities as they cannot take advantage of the direct debit savings that are offered with electricity and gas accounts. Credit unions in the UK have recognised this problem and provide a bill-payment facility. This enables individuals without bank accounts to benefit from purchasing their utilities in the most cost-effective manner.

Microfinance and microcredit

In 1974, an economics lecturer at the University of Chittagong, Bangladesh, lent $27 to a group of impoverished villagers. Thirty years later, the lecturer, Muhammad Yunus, won the Nobel peace prize for his work and microfinance become an important development tool for tackling world poverty, engaging the poorest people and tackling the financial exclusion they experience. Muhammud Yunus founded the Grameen Bank in 1983 to make very small loans to the poor and uncreditworthy. It now has 8 million borrowers, 97% of whom are women, and has issued more than $6bn (£3.65bn), lending around $100m a month, with the average loan of just $220, and repayments of near 100%.[36]

Microcredit is now making the move from the developing world to the developed. Grameen America was established last year in New York City and the programme has 660 borrowers with an average loan of $2200. More projects are planned in cities across the US. The concept is also coming to inner city Glasgow. In Glasgow there are high levels of worklessness and three generations of unemployment is not uncommon within families. A model is being developed to try to assist these people off benefits and become more self reliant.

Microfinance is a simple concept and has had notable success not just in promoting financial resilience but in achieving other social objectives – reaching the excluded, empowering women and developing the capacity of small groups of people to take control of their own lives. It has been claimed that 5% of Grameen Bank's clients exit poverty each year but there are surprisingly few credible estimates of the extent to which microcredit actually reduces poverty due to the difficulty of mapping typical Grameen customers over the long term. Microcredit has instead been proven to be a valuable tool in allowing people to overcome the barrier posed by start up costs, with one third more businesses opening in slums which had a microcredit branch. This identifies the real benefit of this type of finance.

[35] Association of British Credit Unions Limited. See http://www.abcul.org/page/about/financialexclusion.cfm
[36] Interview by Alison Benjamin in The Guardian, 3rd June 2009. See http://www.guardian.co.uk/society/2009/jun/03/interview-muhammad-yunus

Social Investment Wholesale Bank

In July 2009, the Cabinet Office's Office of the Third Sector released a consultation setting out the vision and economic case for a Social Investment Wholesale Bank (SIWB)[37] which if set up would be the first of its kind in the world. The aim of the bank would be to concentrate on supplying funding to third sector bodies, encompassing voluntary and community organisations, charities, social enterprises, cooperatives and mutual's, both large and small. The bank would be an independent social investment vehicle, created using the capital from dormant accounts[38] with founding capital of at least £250 million, and an annual income stream of £20 million for a minimum of four years. Without this type of banking infrastructure, third sector organisations will always find it difficult to access finance and therefore suffer from under-investment in enterprises due to the uncertain price of their risk and most significantly poor mechanisms for signalling social returns.

The idea behind the SIWB is that, as a mission-driven investment bank, it would provide support for those who invest for a social purpose, allowing them to strengthen and develop their reach and capacity. As a wholesaler of social investment, it would support the long-term growth of a thriving third sector by working with investors and lenders at the 'retail' level, and might take greater financial risks or accept less financial return, due to the additional social return generated. The bank would also be able to support organisations such as Charity Bank and CDFI's who themselves focus on supporting third sector organisations that find it difficult to obtain finance from mainstream providers. Another key role for the proposed bank would be to increase the supply of investment, support the demand for finance and develop the social investment market.

Creating a 'Post Bank'

A number of organisations have been exploring how new types of financial institutions could be developed that not only combat social and financial exclusion but bring some much needed competition back into the marketplace. The Post Bank Coalition[39] was formed to promote the idea of a Post Bank.[40] The concept of the Post Bank aims to underpin future sustainability of the Post Office network by greatly expanding the range of services they provide and crucially, by helping prevent any further Post Office closures. Post Office closures damage local economies by reducing money flow locally, by reducing footfall and by creating delays and travel costs for local businesses and people. The Post Bank would be the only institution with a national network that could provide the scale and reach to offer banking services to the financially excluded and the 'unbanked'. The main arguments for a Post Bank were that it would have an extensive reach; be ideally placed for marketing banking services; offer low rates of interest and offer current accounts designed to meet the needs of the financially excluded.

However, the Post Bank Coalition may now have 'reached the end of its natural life' since the idea of a Post Bank appears to have been ruled out absolutely by HM Treasury. While this may not be a viable option under banking reform, the ideas could be adopted in developing other responsible finance institutions, or as part of an agenda to protect local retail / high streets.

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[37] *Social Investment Wholesale Bank: A Consultation on the functions and design*, Office of the Third Sector, 2009. Available at http://www.cabinetoffice.gov.uk/media/224319/13528%20social%20bank%20web%20bookmarked.pdf

[38] Note that the SIWB will utilise only a very small percentage of the total unclaimed assets from dormant accounts – most will go towards developing youth facilities.

[39] Members include the Communications Union, Unite, nef, Federation of Small Businesses, National Pensioners Convention and the Public Interest Research Centre.

[40] *Delivering the Post Bank*, Post Bank Coalition, 2009. Available at http://www.neweconomics.org.uk/NEF070625/NEF_Registration070625add.aspx?returnurl=/gen/uploads/4xf3ow4554jhnv455hd4y5nf14072009113218.pdf

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