

A NEW PUBLIC BANKING ECOSYSTEM

A report to the Labour Party commissioned
by the Communication Workers Union
and The Democracy Collaborative

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This report is the work of independent experts and constitutes a report to the Labour Party's Shadow Chancellor of the Exchequer, John McDonnell MP, and Shadow Secretary of State for Business, Energy and Industrial Strategy, Rebecca Long-Bailey MP. It should not be taken to represent Labour Party policy.

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1 INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

Ten years on from the global financial crisis, our banking system is still not working for the many. Despite having one of the largest banking sectors in the world, the UK has a longstanding problem of underinvestment. While billions of pounds are lent into the economy each year, most of this flows into property and financial markets, inflating asset prices and destabilising the economy. UK banks continue to have low levels of public trust, and have struggled to deal with scandals concerning their conduct. Branch closures have left many households and businesses without access to fair and affordable banking services.

In order to address these problems, it will not be enough simply to regulate existing banks more heavily, or to rely on competition policy as the current government is doing. Instead we need structural change – building a new banking system that puts the public interest first. Labour's 2017 Manifesto proposed the creation of several new institutions designed to start this process:

- a Post Bank to provide a full range of retail banking services through the Post Office network;
- a National Investment Bank, supported by a network of Regional Development Banks; and
- a review of alternatives to re-privatisation for RBS.

This report makes a series of recommendations on how each of these policies could be most effectively designed to fit together as part of a coherent public banking ecosystem. Our recommendations have been informed by an extensive literature review, an expert roundtable, and interviews with key stakeholders from the UK and abroad. Our recommendations are summarised below.

In relation to the Post Bank, we recommend that:

- The partnership with Bank of Ireland UK should be ended, and a new Post Bank should be set up with a separate management team and separate accounting, and endowed with its own capital.
- The Post Bank should be given a public service mandate to provide financial services according to clear principles set out in primary legislation. This should include a requirement to provide access to basic retail banking services to all citizens regardless of income, wealth, or social status, and to contribute positively to the financial sustainability of the Post Office network.
- The Post Bank should be established as a separate legal entity that is required to pay an annual 'access payment' to the Post Office to cover use of its assets, providing the Post Office with a steady and reliable source of income.
- The Post Bank should be owned under a public trust model whereby ownership is held in trust for the public benefit in order to ensure the bank is able to fulfil its public service mandate and safeguard against future privatisation.
- The Post Bank should be governed by a Board of Trustees, comprising elected public representatives and relevant national and regional stakeholders, who would be charged with ensuring that the bank fulfils its public service mandate.
- A comprehensive and legally binding services agreement should be established between the Post Bank and the Post Office, which would set out the relationship between the two entities with regards to issues such as branch access.
- The Post Bank should be set up in a decentralised structure, with lending and decision making devolved to a series of regional offices, and which are not legally separate entities but have a high degree of independence.
- The Post Bank head office should be responsible for providing central support services such as IT, marketing, regulatory

compliance, access to the payments system and a treasury function.

- The range of financial products and services currently offered through Post Office Money should be transferred to the newly established Post Bank, and the Post Bank should seek to acquire the existing Bank of Ireland UK portfolio.
- The Post Bank should be capitalised by HM Treasury with £2.5 billion of capital – to enable the acquisition of the Bank of Ireland UK portfolio and meet network investment needs – and will be funded mainly by retail deposits, including from personal current accounts, business current accounts, and savings products, as well as debt issued to financial markets of varying maturities.
- The Post Bank should seek to grow and expand its market share in the current account, savings, travel, insurance, and personal loan markets, and establish a new business division focused on SME customers, which should be made a strategic priority.
- The Post Bank should seek to develop a business model of ‘relationship banking’, whereby loans are de-risked through building up strong relationships and understanding the businesses it lends to, rather than relying on the availability of collateral.
- The Post Bank should make its products and services available through Post Office branches, over the phone, online, and via mobile banking. Various options, including developing in-house capacity and partnering with a responsible fintech firm, should be considered as part of ensuring that the new Post Bank is able to position itself at the forefront of the fintech revolution.

In relation to the future of RBS we recommend that:

- If a Labour government still has a majority stake in RBS when it comes to power, it should halt plans for privatisation and retain a controlling majority shareholding in the bank.
- The government should use its remaining majority stake in RBS to proactively turn its business model towards one that is more aligned with public interest objectives.
- The government should look to sell or wind-down certain banking divisions of RBS that are held outside the ringfenced bank. It should

also seek to change the management team and corporate governance, stop further branch closures and exert pressure to reform the bank’s culture to stamp out abuses.

In relation to the National Investment Bank (NIB), we recommend that:

- The NIB should be given a broad mandate to support the government’s industrial strategy, through the use of repayable financial instruments.
- The NIB should consist of a head office located outside London, and 12 Regional Development Banks located in each of the nine regions of England, plus Scotland, Wales, and Northern Ireland.
- The NIB and Regional Development Banks should be structured around three operational ‘arms’ – an enterprise arm, an infrastructure arm, and an innovation arm.
- The NIB’s investment activities should initially focus on three core areas which support Labour’s industrial strategy: decarbonisation and greening the economy, regional rebalancing, and industrial transformation and economic democracy.
- The NIB should create products that target particular issues that are aligned with the government’s industrial strategy, rather than offer generic products, to support structural change.
- The enterprise arm of the NIB should on-lend via bank intermediaries for customers that are small businesses. On-lending should be used as a tool for promoting wider structural change in the financial sector by lending through favoured institutions such as the Post Bank. For medium and large firms, infrastructure projects and venture capital investments, the NIB should lend directly via the Regional Development Banks.
- The NIB should be capitalised by the government with £10 billion of paid in capital, and £10 billion of callable capital. The NIB should subsequently conduct annual bond issues to expand the NIB balance sheet to approximately £250 billion over a ten year period.

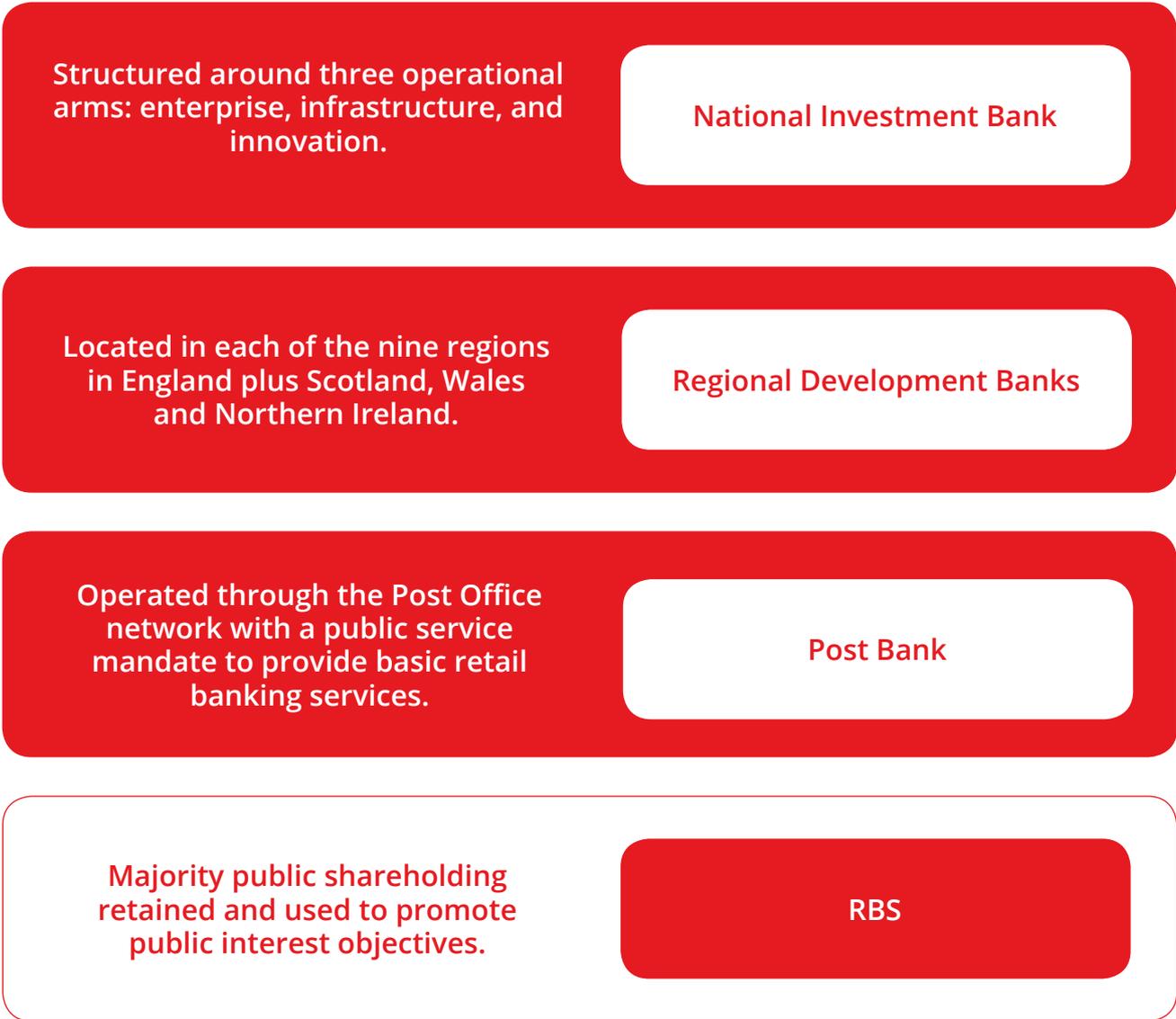
In relation to a series of cross cutting issues, we recommend that:

- A Labour government should consider new measures that would require other large

incumbent banks, including RBS, to support the Post Bank, for example through incentivised switching schemes or premises in areas where banks are closing branches.

- Skill sharing partnerships should be formed with international public interest banks in order to learn from best practice and develop the skills and capacity that are currently lacking in the UK.

Figure 1 Summary of public banking ecosystem



2 THE PROBLEMS WITH THE UK BANKING SECTOR: WHAT ARE WE TRYING TO ACHIEVE?

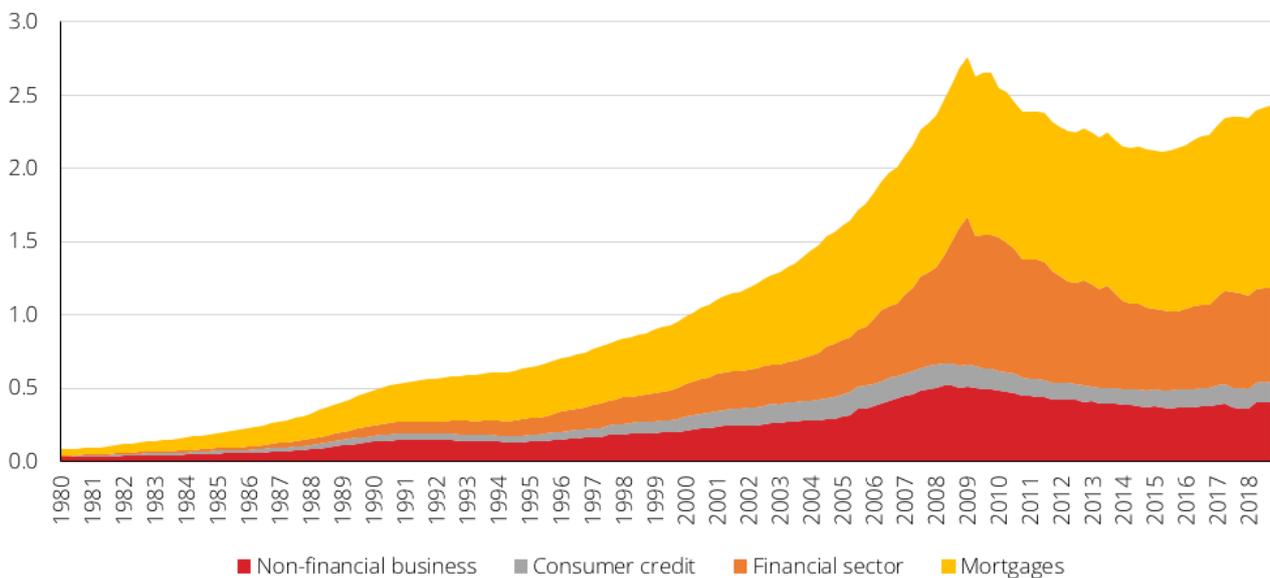
The UK has one of the largest, least diverse, most complex and interconnected financial systems in among advanced economies.¹ In contrast to many other countries, the banking sector in the UK is dominated by a handful of large, shareholder-owned universal banks, whose main aim is to maximise shareholder return. The UK is also unusual in that it lacks a significant local or regional banking presence – the market is overwhelmingly dominated by national and often internationally orientated banks. These features contribute towards a number of social and economic problems.

2.1 Financialisation and lack of funding for the real economy

In recent decades, the UK's banking sector has grown rapidly relative to the non-financial sector. In 1960 UK banking sector assets totalled £8 billion, or 32% of GDP, but by 2010 this had

increased to £6,240 billion, or 450% of GDP.² However, much of the growth in banking sector activity in recent decades has happened outside the sphere of production. While in the past most bank lending financed productive business investment, in recent decades banks have increasingly favoured lending to other financial institutions (financial intermediation) and for real estate (household secured and commercial real estate)³ – lending which does not increase the productive capacity of the economy. This has triggered a shift in the role that retail banks played in the British economy, from mainly lending to businesses for productive investment, to primarily lending to finance the purchase of existing assets.⁴ Bank balance sheets have expanded through the proliferation of complex financial instruments such as securitised mortgages, commodities futures, and a range of other financial derivatives. The result is that since the 1980s the share of lending going to businesses has been falling rapidly.

Figure 2 Total stock of outstanding loans, UK banks (£ trillion)



Source: Bank of England⁵

Part of the reason for this can be found in the evolution of banking business models away from a primary focus on payment services, deposit-taking activities and business lending, and towards a broader range of activities such as securities underwriting and trading, fund management, derivatives trading and general insurance.⁶ A number of factors have helped to produce a UK banking system which is dominated by a handful of large, shareholder-owned universal banks, the most important of which were the process of demutualisation and the 'Big Bang' deregulation in the 1980s.⁷ What were 32 separate entities in 1960 had by 2010 become consolidated into six major groups – Barclays, HSBC, Lloyds, Nationwide, RBS, and Santander – which together had an 89% market share of the current account market.⁸

The rise of so-called 'universal' banking has also changed the nature of business lending, which has shifted away from relationship-based branch lending towards centralised and automated credit-scoring techniques, and a strong preference for collateral. A recent Bank of England survey of major lenders found that 68% of lending to SMEs and mid-size corporations (by volume) is secured on property, with 34% of lending secured with a personal guarantee, typically with an explicit or implicit claim against their residential property.⁹ This can often act as a constraint on the ability of firms to borrow; in a recent Bank of England survey, nearly 25% of SMEs said they were constrained in their borrowing by the need to provide collateral.¹⁰

Moreover, the growing focus on short-term return on equity to boost share prices has shifted attention away from lending to productive enterprise. SME lending – often involving high transaction costs for relatively small loans – is particularly unattractive to large universal banks as it contributes little to the rate of return on equity compared with mortgage lending and financial sector lending.^{11 12} This is particularly relevant in the UK, which is uniquely dependent on commercial banks seeking to maximise shareholder return.¹³

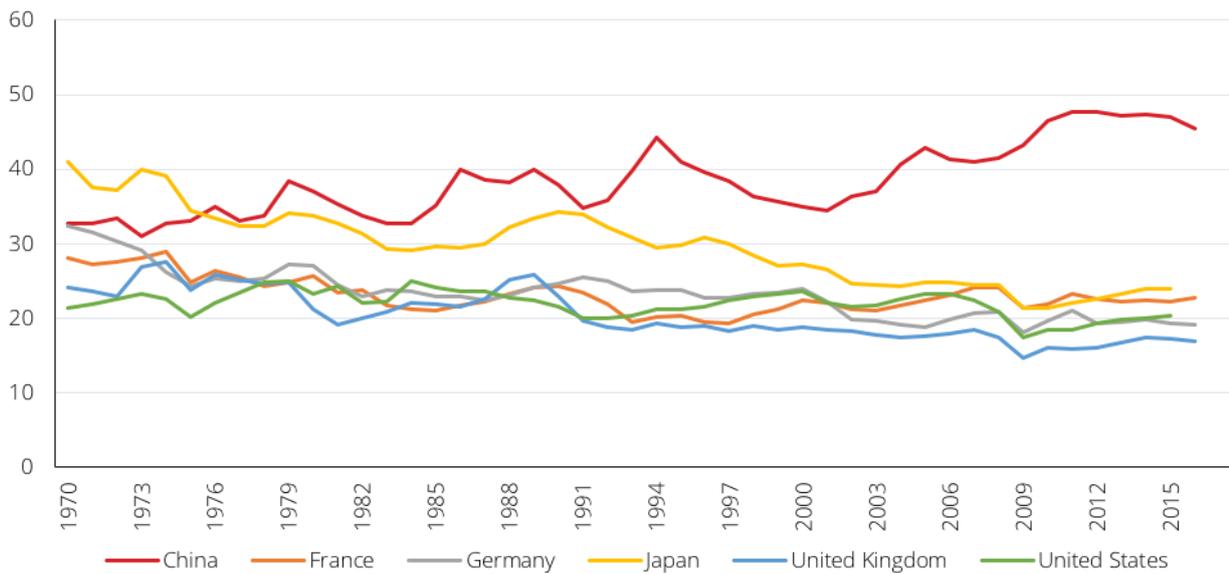
Taken together, these factors appear to be contributing towards supply side constraints on the availability of credit for investment. A recent Bank of England survey found that 20% of firms are under-investing because they are unable to access the bank credit they need to expand,¹⁴ while the British Business Bank acknowledges that a lack of finance to smaller businesses is contributing to lost output and growth.¹⁵ Although bank lending remains the single largest form of lending for SMEs, in recent years there has been an increase in financing from alternative sources such as private equity, peer-to-peer lending, crowdsourcing and non-bank debt funds.¹⁶ However, these sources tend to be more expensive, relatively small in scale and are heavily skewed toward London and the South East.¹⁷

2.2 Under-investment in the productive economy

Somewhat paradoxically, despite having one of the largest financial sectors in the world, the UK has a longstanding problem of underinvestment compared to other advanced economies. In 2016 public and private investment was 17% of GDP – 24th out of 28 EU countries and ranking 118th in the world.¹⁸ Only Greece, Cyprus, Portugal and Lithuania were lower in Europe, while all other major advanced economies invest significantly more. The level of investment in the UK has been falling for much of the past half century, at the same time as the financial sector continued to grow ever larger. The link between the UK's low investment, low productivity and stagnating wages is now increasingly being recognised.^{19 20}

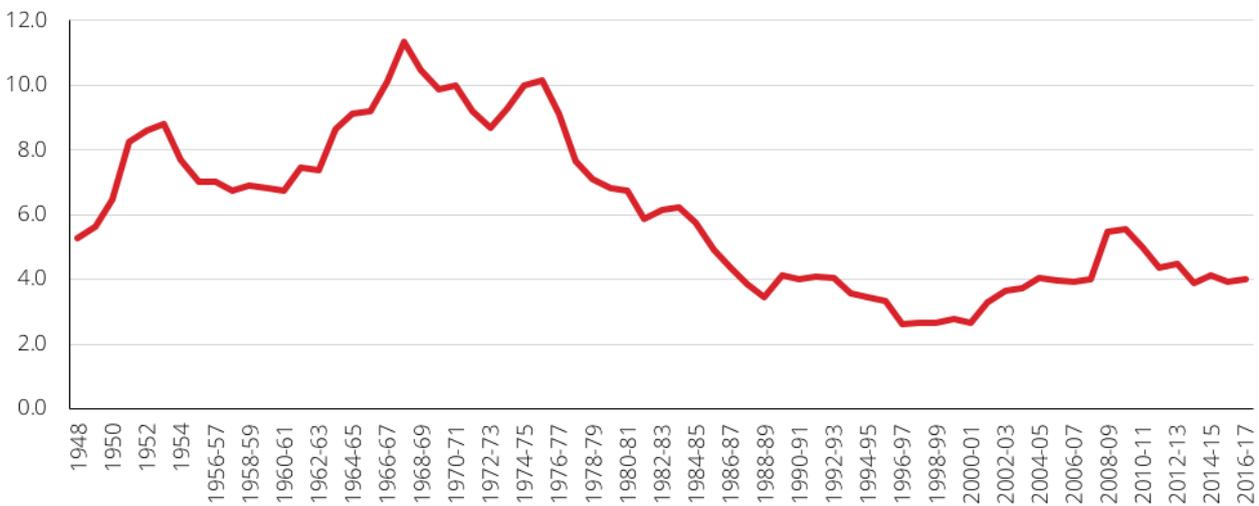
As well as falling business investment, these trends have also been exacerbated by declining levels of public investment. As shown in Figure 4, UK public sector gross investment (PSGI) has decreased significantly as a proportion of GDP over the past 50 years. Much of this reduction resulted from the transfer and sale of assets from the public to the private sector since the 1980s, including the Right to Buy scheme and the privatisation of the energy, transport, telecommunications and water utilities.²¹

Figure 3 Gross fixed capital formation (% of GDP)



Source: World Bank²²

Figure 4 Public sector gross investment as a % of GDP, UK



Source: Office for Budget Responsibility²³

However, it is now increasingly recognised that successive governments have underinvested in key strategic areas such as energy and transport, which has held back the UK's economic potential. A recent OECD study found that infrastructure in the UK has suffered from under-investment compared with other major advanced economies over the past three decades.²⁴ The study concluded that this is partly attributable to insufficient long-term planning by successive

governments, and noted that rising private sector participation since the 1980s may have led to sector fragmentation and impaired the ability of government to take a cross-sector, holistic view of the country's infrastructure needs. The study ranked the UK second last out of the G7 countries for overall infrastructure quality, and highlighted a stark regional disparity in the quality of infrastructure between the South East (including London) and the rest of the country.

In addition, there has been a shift away from direct public investment towards off-balance sheet private sector financing schemes. Since being introduced in the mid 1990s, the Private Finance Initiative (PFI) model has been used extensively to deliver infrastructure projects across the UK. Under the PFI model, projects are financed with private debt and equity and governments then pay an annual payment to private contractors over many decades which covers the capital repayment plus interest and maintenance costs, which is usually indexed to inflation.

The rationale for funding infrastructure projects using the PFI model is that the projects are held off the public-sector balance sheet and thus do not contribute to public sector net debt (PSND) or public-sector net borrowing (PSNB). However, using PFI to deliver infrastructure projects is significantly more expensive than using conventional public borrowing. According to HM Treasury, the cost of servicing private finance debt is more than double that of government debt, with the cost of government borrowing averaging 3% to 4%, compared with an estimated financing cost of 7% to 8% for all private finance projects.²⁵ In total, there have been over £58 billion worth of projects financed through PFI in the UK since 1998. Under the current payment arrangements the cost to the public purse of financing and maintaining these assets will amount to a cumulative total of nearly £310 billion by 2047-48.²⁶

The European Investment Bank (EIB) has long been a key source of finance for infrastructure projects in the UK, financing £7 billion of projects in 2016. However, following the UK's vote to leave the European Union the EIB has decided to put its UK operations on hold, creating a potentially significant gap in the availability of low-cost, long-term financing for infrastructure projects.²⁷ A number of studies, including the LSE Growth Commission,²⁸ have called for a new infrastructure bank to be established to facilitate the provision of finance for infrastructure projects and reduce and manage risk.

2.3 Regional imbalances in bank lending and economic prosperity

The UK's vote to leave the European Union exposed deep underlying regional divides. Research conducted since the referendum has found that geographical distribution of living standards played a key role in determining how people voted.²⁹ Part of the reason for this can be found in the UK's notoriously uneven economic landscape. The UK is the most geographically unequal country in the EU. While inner London is by far the richest single area, West Wales and The Valleys is poorer than some recent EU accession countries.³⁰

The UK's highly concentrated banking sector has reinforced these geographic imbalances, and contributed towards the growing polarisation of the UK economy. Without a focus on specific geographical areas or social objectives, the large banks that dominate the UK banking landscape choose to allocate their capital to the most profitable activities, and lending to underserved areas is less profitable than lending to wealthier parts of the country where credit risk is lower and demand is higher. Of the business lending that does occur in the UK, most is heavily concentrated in London and surrounding areas. According to the most recent available data, 33% of SME lending goes to London and the South East compared to just 8% to Scotland, 5% to Wales and 3% to the North East.³¹ This has contributed to the rise of payday lending and other forms of high-cost credit in many areas.

By leaving many regions on the wrong side of the UK's finance-led economy, the UK's homogenous and highly concentrated banking sector has contributed towards a lack of productive investment and growing regional imbalances.

2.4 Decline of access to affordable basic banking services

In the UK, 1.5 million adults remain unbanked,³² while 3.8 million UK households do not have internet at home and 12 million people live in rural or remote areas of the UK where poor internet access makes it difficult to bank online.³³ Meanwhile, a growing number of communities are being left without access to banking services

as branch closures accelerate across the country, with devastating consequences for small businesses and local communities.^{34 35} Evidence also suggests that branch closures are having a significant economic impact by negatively affecting SME lending.³⁶ As has been recently noted by the FCA:³⁷

“bank branch closures are commercial decisions by banks that may disproportionately affect certain consumer segments such as older people, those in low-income communities... and small business.”

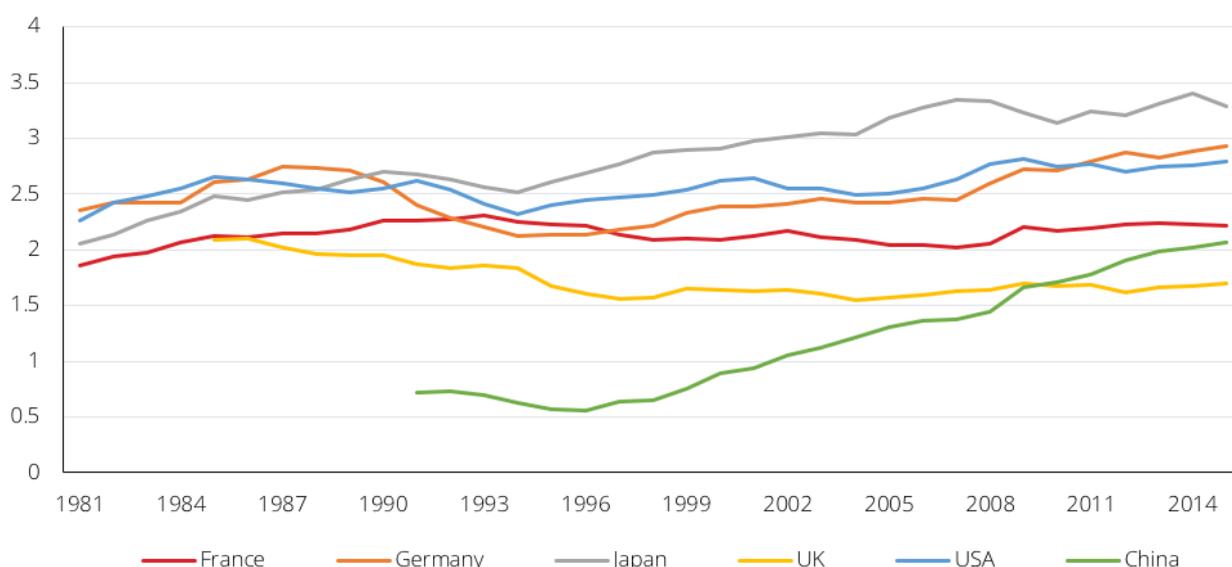
2.5 Lack of investment in innovation and R&D

Finance is central to any system of innovation because it provides access to high-risk capital for firms interested in engaging with new technologies: from IT, to nanotech and the emerging green-tech industry. An imperfect but useful proxy for investment in innovation is gross research and development (R&D) spending relative to GDP. In the UK, public and private investment in research and development has fallen over the past 30 years and remains lower than other major advanced economies. In 2015, the UK invested 1.7% of GDP in R&D, compared with 3.3% in Japan, 2.9% in Germany, 2.8% in the US, 2.2% in France and 2% in China.

Because innovation is highly uncertain and has long lead times, it requires long-term, patient, committed finance.³⁸ By nature, financial returns from investment in innovative activities are not always assured, and it usually takes time before they can materialise. As a result, the private sector will often not invest in such high-risk areas until future returns become more certain – particularly in the UK which is dominated by short-term, speculative finance.

In the regions and countries that are the most innovative, public sources of finance play a key role supplying the patient strategic finance that the private sector is unwilling to provide. These entities invest not only in basic R&D, but also in basic research, applied research and early-stage and scale-up funding of innovative companies. This early stage public investment helps to create and shape new markets, creating a new landscape which the private sector later develops. From advances such as the internet and microchips to biotechnology and nanotechnology, many major technological breakthroughs – in both basic research and downstream commercialization – were only made possible by direct public investment. In each of these areas the private sector only entered much later, piggybacking on the technological advances made possible by public funds.³⁹

Figure 5 Gross domestic spending on R&D, 1981 – 2015 (% of GDP)



Source: OECD⁴⁰

The UK is unusual among major advanced economies in having few public sources of long-term, patient, committed finance, which partly explains its poor performance in relation to innovation and R&D. However, simply increasing the quantity of finance will not on its own increase innovation. If there are not enough innovative firms willing to invest in innovation (i.e. if there is insufficient demand for finance) then innovation will not happen.⁴¹ The challenge is therefore not just how to provide finance to businesses, but how to stimulate their courage and desire to do so.

2.6 Lack of financial system resilience

The lack of diversity in the UK banking sector means that it is uniquely vulnerable to financial crises. This is because similar institutions with similar business models are likely to suffer from

the same problems at the same time, increasing the chance of a systemic crisis. When a shock such as the 2008 financial crisis hits, if banks have different operating models, they are affected in different ways, reducing the risk of the contagion spreading throughout the entire financial system.

The domination of the UK banking sector by a small number of big banks with similar business models, along with their size, complexity and interconnectedness, means that the UK has one of the least resilient financial systems among advanced economies.⁴² A resilient banking system requires a diversity of providers for consumers to choose from, rather than simply a larger number of major players following the same business model.

3 DESIGN PRINCIPLES: HOW CAN NEW INSTITUTIONS HELP TO OVERCOME THESE PROBLEMS?

If we want to address these problems, it will not be enough simply to regulate existing banks more heavily, or to rely on competition policy as the current government is doing. This has been the approach taken since the financial crisis, and this has failed to deliver meaningful change. Instead, we need structural change to reorient the banking system towards serving the public interest.

This means promoting new banking models at different scales – national, regional and local – which are mandated to serve the public interest rather than simply to maximise returns. These banks are often referred to as ‘stakeholder banks’ – an umbrella term referring to any bank which is run in the interests of a wider group of stakeholders rather than only in the interests of shareholders. This includes public banks, co-operative banks, mutuals and building societies, as well as credit unions and responsible finance providers. There is now strong international evidence that stakeholder banks perform better than shareholder banks on a wide range of measures:⁴³ they lend proportionately more to the real economy,⁴⁴ (including small business lending), maintain larger branch networks,⁴⁵ produce more consistent and less volatile returns,⁴⁶ have safer business models with higher loan quality,⁴⁷ and are less likely to fail or cut back lending in times of crisis.^{48 49} There is also evidence that the presence of a robust stakeholder banking sector improves wider economic outcomes such as reducing regional inequality^{50 51} and enhancing resilience to economic shocks.

Labour’s 2017 Manifesto proposed the creation of several new institutions designed to move towards a banking system that serves the public interest:

- A Post Bank to provide a full range of retail banking services through the Post Office network – such as current and savings accounts, mortgages and small business loans.
- A review of alternatives to re-privatisation for RBS, including the possibility of breaking it into a network of local public banks.

- A National Investment Bank (NIB) and Regional Development Banks (RDBs), to mobilise large amounts of capital and steer it towards public priorities.

In designing this new system we do not have to start from scratch: we can learn from other countries, such as Germany and France, where such banks are often the backbone of the economy. In the following sections, we review the evidence from other countries to inform the design of a new banking ecosystem for the UK. As the Post Bank and RBS relate to retail banking, we first review the evidence on the key features of successful public-interest stakeholder banks, and then do the same for national investment banks.

3.1 Key features of successful public-interest retail banks

Although the evidence clearly shows the benefits of retail banks that are owned and run for the benefit of stakeholders – including public banks – it would be wrong to assume that simply having a publicly owned bank, such as the Post Bank or a state-owned RBS, will in and of itself necessarily deliver these benefits. Rather, in successful stakeholder banking models, the ownership arrangements are linked to a number of other interlocking features which are mutually reinforcing and can be linked to the various benefits they produce. Looking at the evidence on these features can give us ‘design criteria’ for the Post Bank as well as informing policy options for RBS.

This does not mean simply copying models from overseas, but rather seeking to understand the features that make them work and adapt these features to the UK context. Failing to do this could mean that new public banks fail to produce the expected benefits. There are many examples of where public banks have been poorly run and managed, or where they have evolved over time to behave more like existing large commercial banks.

3.1.1 Ownership and governance: stakeholder accountability

The basic fact of public or stakeholder ownership is of course important, since it gives banks different incentives to shareholder-owned banks and means they are accountable to different interests. But again, the evidence indicates that there are a number of specific features which matter:

- They are **profit-making but not profit-maximising**, meaning they are less vulnerable to pressure to boost short-term returns by taking on excessive risk, exploiting customers, or over-expanding into new markets or areas of activity. Not having to maximise returns to investors also gives them a lower cost of capital, making it easier for them to remain financially sustainable whilst maintaining a relatively high cost base (e.g. by having larger branch networks and more local staff).
- In the case of some public banks, such as the German Sparkassen, this is linked to an explicit **public service mandate** defined in legislation which ties them to a specific public mission (e.g. promoting saving, supporting regional economies, etc).
- Their **governance structure** gives voice to those with an interest in the bank's public purpose: for example, Sparkassen supervisory boards are made up of representatives from the local authority, staff and local community. In co-operative banks, the board are elected by the members of the co-op (usually customers/borrowers, although staff will often also be members).
- Their **ownership structure** makes it more difficult for the bank to be sold to the private sector whilst limiting the ability of the current 'owners' to take value out of the business or pressure it to prioritise short-term returns. For example, the Sparkassen are owned by local municipalities under a special form of ownership which is not tied to a tradeable financial asset and thus cannot be sold. Co-operative members have rights only over the nominal value of their paid-up membership stake, not the entire reserves and economic value of the bank, and the distribution of profits is limited.⁵²

Taken as a whole, these ownership and governance features contribute to stakeholder banks being safer, more risk-averse, and more

stable than shareholder-owned banks. Related to this, these ownership and governance features likely help to preserve their focus on customer-driven, local relationship-based banking and to make this business model viable. Of course, not all stakeholder banks display these benefits equally: for example, some co-operative banks have evolved over time to become more like commercial banks as legal restrictions on their activities have been relaxed, while both public and co-operative banking networks have sometimes developed an empire of central commercial arms which over-reach into new business areas (such as investment banking) or new markets (such as the Austrian co-operatives' expansion into Eastern Europe). In particular, the evidence indicates that 'hybrid' models which combine local stakeholder governance with centralised, shareholder-owned subsidiaries run on a commercial basis can over time dilute and erode the distinctiveness of stakeholder banks – something which should be considered in the context of the Post Bank.

3.1.2 Business models focussed on relationship-based retail banking

One key feature of stakeholder banks is simply that they tend to be focussed on more 'traditional' retail banking. This means they fund themselves largely through customer deposits and their assets are primarily composed of loans to households and businesses – in contrast to large universal banks who increasingly fund themselves by borrowing from other financial institutions, and whose assets are increasingly dominated by tradeable financial instruments such as securitised loans and derivatives.⁵³ In some cases, for example with some public banks, these restrictions on banks' activities are explicitly enshrined in legislation.

Stakeholder banks also tend to be more equipped to undertake 'relationship lending' – managing risk by building interpersonal relationships with borrowers rather than through credit scoring algorithms or reliance on collateral – although this in turn is partly a function of their ability to maintain high-cost branch networks and staff (due to not being profit-maximising) and their decentralised structure. There is evidence that relationship lending has benefits for borrowers – particularly in contexts where there is some competition (as otherwise an exclusive long-term relationship with a particular bank can make borrowers vulnerable to exploitation).⁵⁴ This type of lending is also much more conducive to making

small loans to SMEs a key part of a viable business model, whereas for large commercial banks this type of lending tends to be relatively unprofitable and does not play to their strengths. However, this need not necessarily be the case if a bank chooses to make local relationship lending a core part of their business.

These features are partly responsible for stakeholder banks' superior contribution to the real economy (since this is their core business) and their greater stability (since they do not engage in risky speculative activity). Having said this, as noted above, the wider groups which local stakeholder banks belong to sometimes do over-extend themselves into other types of financial services, setting up profit maximising arms providing investment banking and other services. The regional and central institutions which support local stakeholder banks (such as the German Landesbanken or the German co-operatives' DZ Bank) have also become entwined with the capital markets through their role as interface between local banks and capital markets, which during the financial crisis meant that some ran into problems due to having 'toxic assets' on their books.⁵⁵

All of this points to the desirability of legally restricting the activities of any new public bank to ensure that they remain focussed on providing retail banking services to households and small businesses, and do not over-reach into other, riskier or less socially useful types of activity. It may also be desirable to limit the types of investments that can be made by the Bank's central treasury function to avoid exposing it to undue risk in the capital markets. At the same time, it is worth noting that part of the driving force for over-expansion by some stakeholder banking networks in Europe has been the need to shore up profitability when the bank is not achieving sufficient yields through its core business (for example because interest rate spreads are low). The potential tension between a public bank's public service mission and its aim of providing a revenue stream to its owner must therefore be carefully managed.

3.1.3 Decentralised local banking models

European stakeholder banks tend to be structured as independent local banks, restricted only to providing banking services within their local area (the 'regional principle'), co-operating in networks to achieve economies of scale and pool

risk. However, they vary widely in the degree of integration and centralisation within the network. While some form of central co-ordinating body is usually present, these range from being a hub for things like training and external representation, to being fully fledged banks which act as a central bank for the group members (and in some cases also serve commercial clients) – for instance, managing members' liquidity by redistributing it between local entities and investing the excess in capital markets, operating centralised asset-liability management and risk management, as well as providing IT services, product development and marketing.⁵⁶

Networks also vary in their degree of risk sharing, with some having cross-guarantees (where the central body commits to provide liquidity to local entities in trouble) or even full joint liability (where the group commits to honouring local creditors if the local entities fail). In some cases, such as the German co-operatives, regional associations audit local banks, holding management to account and determining their level of contribution to the common guarantee scheme based on their riskiness.⁵⁷ In some highly integrated cases, the group is treated by regulators as a single entity for prudential purposes, with the relationships between individual local banks regarded as an internal governance matter even though they are technically separate legal entities.⁵⁸ In other words, it is more helpful to view the range of options for public and stakeholder banks as a spectrum between centralisation and decentralisation, rather than a binary choice between a single national bank and a network of local banks.

Localisation and decentralisation is important for stakeholder banks' ability to make a success of relationship-based business models that prioritise lending to small businesses and households. Accountability of central bodies to local entities, rather than the other way around, may also reduce the risks of over-expansion and over-reach discussed above, keeping the group focussed on its mission of serving local economies. Both bank size and organisational structure affect banks' ability to spread their lending equitably across regions and to build supportive long-term lending relationships with small businesses. As a recent review of the literature concludes, "there is robust evidence supporting the importance of agency and influence costs in banking organisations and the disadvantages of large, complex bank organisations in small business and relationship-based loans".⁵⁹

Evidence suggests that this is not simply about banks' local presence (for instance in terms of branches or staff with knowledge of the local economy), but is also to do with organisational structure and decision-making processes. Centralised, hierarchical banks have greater incentives to rely on 'hard' information which is easier to store and communicate within the organisation, while more decentralised banks are more able to make use of 'soft' information of the kind which underpins relationship lending.⁶⁰ The more layers of hierarchy a local loan officer must go through in order to gain approval for a lending decision, and the further these decision centres are from the local branch, the less able the bank is to make use of this information – and the less likely they are to build supportive lending relationships with SMEs.⁶¹ Evidence also suggests that trust is a key component of the resilient lending relationships developed by banks such as the German Sparkassen, which again implies a high degree of importance for face-to-face relationships with local loan officers who are empowered to make lending decisions.⁶²

Indeed, evidence suggests that the distance between a local branch and the bank's headquarters may be more important than the distance between branch and borrower in determining levels of SME lending. For instance, this was the conclusion of a study of Italian banks, which found particularly adverse effects for small businesses in less developed regions which were further from bank headquarters.⁶³ Southern Italian banks that are part of banking groups headquartered in the centre or north of Italy have also been found to be less efficient and lend less to small businesses than those headquartered in the south.⁶⁴ The large regional disparities between the Italian north and south make this a potentially relevant comparison for the UK economy.

There is also some evidence that loan quality declines when banks are headquartered further from borrowers. Anecdotally, insiders at overseas public banking networks told us that credit default rates increase when these banks lend outside their 'home' areas. The abandonment of the regional principle was seen as one factor in the failure of the Spanish *Cajas*, or public banks.⁶⁵ Finally, such lending appears to be less resilient in times of crisis. One study of post-crisis SME lending in the UK found that lending contracted more in local areas that were further away from bank headquarters (a 'flight to headquarters' effect),⁶⁶ a finding that has been replicated in other countries.⁶⁷

This evidence may suggest that if we want to promote relationship lending, the most important factor is not the size of the banking entity *per se* (e.g. local or national) but rather the decentralisation of decision-making. This is supported by some empirical evidence that even within large commercial banks, decentralising decision-making improves their ability to use soft information when assessing borrowers.⁶⁸ Having said this, there is some evidence that bank size *per se* affects levels of SME lending. Mergers are generally associated with a decline in SME lending⁶⁹ (and evidence does not suggest this is because bad loans were being made previously). Big banks' provision of small loans also tends to be less robust in times of crisis than small banks.⁷⁰ This may be because larger banks lend themselves to specialising in activities with economies of scale, such as providing investment banking services to large corporate clients and derivatives trading.⁷¹ Conversely, the costs of monitoring the quality of local loans are higher – and if the parent bank is ultimately liable for losses, there will always be organisational pressures to put in place controls on the autonomy of local loan officers. As Alessandrini et al conclude, "whatever the combination of delegation and centralisation of lending decisions chosen at the parent bank, significant organisational diseconomies arise [in larger banks] that reduce the profitability of soft information loans".⁷²

The above evidence suggests that local decision making is important in realising the benefits of regional rebalancing and strengthening local economies. As well as localised decision-making, there is a question here about the role of localised balance sheets. The Sparkassen stress that the 'regional principle', under which local deposits can only be used to back local loans, allows them to keep wealth recirculating within local economies, rather than deposits being centralised in a single bank balance sheet and reallocated to more profitable lending opportunities in more prosperous regions. This logic fits well with Labour's existing commitment to community wealth building.⁷³

However, there are legitimate questions about how this dynamic would play out in an already highly regionally unbalanced economy like the UK. One could argue that the reverse is true: fully localised banking would restrict the growth of bank balance sheets in more deprived areas where deposits grew more slowly, exacerbating existing regional imbalances. By contrast, combining centralised funding with decentralised

decision-making might allow for deposits in more prosperous regions to be used to back loans in more deprived regions, thus aiding regional rebalancing. However, given the evidence above, achieving this would likely require the bank concerned to have a strong regional and local focus. Without this, if funding is allocated centrally and individual loans made on a purely commercial basis, it is likely to reinforce rather than reduce existing regional imbalances.

What does all this mean for the Post Bank? It does not necessarily suggest the need to set up a network of legally independent entities rather than a single national Post Bank, but it does suggest the need to devise a meaningfully decentralised governance model, focussed on promoting local banking and accountability to local communities. This might include:

- Headquartering the bank outside London, perhaps in the north of England
- Structuring the bank into local or regional units with meaningful strategic decision-making responsibilities, including monitoring and approval of local loan officers' decisions where this is needed
- Devising a governance structure in which local entities can hold the central management to account, as well as the other way around
- Decentralising individual lending decisions by giving autonomy to local loan officers (given the skills gap discussed below, this may take time to fully implement given the need to manage the bank's risk and loan quality)

3.1.4 Key features of successful retail banking systems

When designing new public banking institutions, it is vital to remember that they will not exist in a vacuum. One of the key lessons of the 2008 crisis was the need to take a systemic perspective on the banking system. Regulators who had been focussed on the apparent safety of individual banks failed to spot the build-up of risks to the system as a whole, as the mortgage market overheated, the size of the financial system ballooned, securitisation proliferated and banks became more interconnected. In the same way, if we focus solely on designing 'good' new public banking models and do not attend to the ways in which these new banks will interact with the rest of the system, we may fail to realise the expected public benefits, or even trigger unintended consequences.

It is now widely accepted that diversity is a key feature of well-functioning banking systems.⁷⁴ A diverse banking ecosystem makes it less likely that many institutions will fail in the same way at the same time, or that the failure of one or two key players will trigger system-wide collapse. It also gives customers more choice; the UK banking system at present is extremely oligopolistic and this enables it to extract excess profits from bank users. However, it's important to emphasise that diversity is different from competition, in that it does not only mean having a larger number of players in the market (as opposed to the UK's over-reliance on a handful of very large banks): it also means having a diversity of different *types* of bank with different incentives and business models.

In particular, recent studies have argued that the evidence on stakeholder banks suggests that "ownership pluralism should become a policy objective in the banking industry".⁷⁵ Many other European countries have 'three pillar' banking systems made up of strong public banks and co-operative banks alongside commercial banks (although the role of public and co-operative banks has been eroded in many countries in recent decades, albeit not to the same extent it has in the UK). This dynamic appears to have benefits for the system as a whole in terms of financial stability, economic resilience and customer service.⁷⁶

The distinctive features of public banks and co-operatives mean that they each have strengths and weaknesses built into their governance models. For instance, co-operatives have the advantage of a strong member focus and limited incentives to profit-maximise, but the disadvantage that in practice member control over management can be weak, that management can have incentives to 'empire-build' by reaching into new markets and eroding their distinctiveness, and that it can be hard for them to raise capital.⁷⁷ Public banks, if poorly structured and governed, can be vulnerable to excessive political control and corruption, resulting in them making unsound lending decisions or taking on excessive risk, as happened in the case of the Spanish *Cajas*.

It is also suggested that, while competition between similar types of bank may be less beneficial than is often assumed (and may even be damaging as banks aggressively jostle to expand market share), competition *between* types of bank (e.g. a local co-operative bank and a local public bank) may improve outcomes for customers by preventing a single bank or

banking model from acquiring excessive market power.⁷⁸ This suggests that the UK could benefit from cultivating a three-pillar system containing public banks (i.e. the Post Bank), other types of stakeholder banks (e.g. cooperative banks and responsible finance providers) and commercial banks.

However, trying to create a new public and co-operative banking system in the UK context is a very different thing from sustaining public and co-operative banks which have grown up organically over many decades. The UK's three largest banks control around half of total assets,⁷⁹ and it is well known that customers are generally not prone to switch banks even when they are getting a poor deal. It is possible that the success of these two new types of bank could become a zero sum game, with each taking business from the other rather than from the existing big banks, thus threatening their financial viability. This would have negative implications for the diversity and resilience of the banking system.

Thought should therefore be given to how to avoid this scenario and build up the Post Bank by taking market share from existing big commercial banks, rather than fledgling cooperative banks or responsible finance providers. In section 7.2 we discuss how this might be achieved, for example through a windfall tax on large banks or regulator-led incentivised transfer schemes to move customers from big incumbent banks to the Post Bank. We also suggest that the National Investment Bank should see its role as in part to cultivate the wider banking ecosystem through which on-lending can take place effectively, seeking to build additional capacity for relationship lending in the system rather than simply to disburse credit through existing channels. Such policies are not an optional extra but could prove crucial both for enabling the Post Bank to build up market share (a key challenge, especially in the small business market), and for ensuring it does so in a way that delivers genuine additional public value.

It is also important to remember that the behaviour of existing large commercial banks will necessarily have an impact on new public banks, and vice versa. As we have seen, stakeholder banks in Europe are not insulated from the capital markets. Their regional and central bodies often ran into difficulties in the 2008 crisis because they had invested excess liquidity in what they thought were 'safe' triple-A rated assets which in fact turned out to be toxic. In other words, they

ended up on the other end of deals originated by banks like Goldman Sachs. Steps may need to be taken to limit this risk, for example in the case of the Post Bank by limiting the types of assets it can invest in. But this is not a substitute for effective regulation of large commercial banks to limit excessive risk-taking.

Conversely, the effect of a new Post Bank on the wider system will in part depend on how existing big banks respond to its entry into the market – for example, if it does become the preferred bank for large numbers of creditworthy retail customers seeking basic banking services, or if its competitive presence helps to drive down margins on this type of business, will this push big banks further towards more risky activities or towards mis-selling in order to maintain profitability? Again, this risk points towards the need for more effective regulation of big banks in order to avoid unintended consequences and ensure that the Post Bank's overall impact on the banking system is positive.

We do not wish to pretend that European stakeholder banks are a perfect model or are without their problems. On the contrary, it is important that we learn from the challenges they have faced as well as their benefits in designing new public banks for the UK. Three key issues in particular are worth highlighting.

Firstly, some stakeholder banks have faced increasing pressure on their traditional banking business models due to persistent low interest rate margins since the financial crisis. This is because they rely on the difference between the interest paid to savers and charged to borrowers to make profits, to a much greater extent than large commercial banks who make money from selling other products and services, as well as from proprietary trading. As discussed above, in some cases this has resulted in pressure to expand into new markets or activities, or to cut costs by shedding staff.

Second, although they do maintain significantly larger branch networks than shareholder banks (especially in remote rural areas), stakeholder banks have not been immune from the rise of **digital banking** and from the pressures put on their business model by the high costs of maintaining branches. For instance, in 2016 the Sparkassen closed 922 branches, the most of any banking institution in Germany (though their branch network still remains the largest),⁸⁰ along with the loss of some jobs.⁸¹ This is a potential

benefit of the Post Bank model, since it makes use of the Post Office's existing branch network that will always be retained, rather than requiring the bank to build and maintain a large independent branch network. Of course, any successful new bank today will need to have a strong online and digital banking offer as well as an advantage in branch-based banking.

Finally, stakeholder banks face **regulatory constraints** since prudential regulation is designed around the needs of large commercial banks. Risk-weighted capital requirements militate against relationship lending models since the types of loans involved generally carry higher risk-weights. There is evidence that the specialisation benefits of relationship banking outweigh the downsides of being less diversified when it comes to banks' ability to manage risks and minimise bad debts, but microprudential regulation does not take this evidence into account.⁸² Meanwhile, the sheer complexity of regulation favours large established banks with big compliance teams, posing disproportionate burdens for smaller or newer banks. There is evidence that this has taken a toll on stakeholder banks across Europe since the financial crisis.⁸³ In future, it may therefore be desirable to explore options for modifying the domestic regulatory system to recognise the distinctive business models of stakeholder banks as well as the systemic benefits of banking diversity, rather than trying to force them into the mould of large commercial banks. Longer term, pressure could also be exerted to reform international regulations such as the Basel agreements to tilt the playing field back towards desirable public interest banking models.

As already discussed, in taking these lessons on board we also need to consider the specific challenges involved in trying to build new public banks in the UK context. The UK economy is chronically regionally unbalanced, has high levels of inequality and financial exclusion and a relatively weak SME sector. This may mean that a Post Bank with a mandate to support SMEs across the country, and to provide universal access to basic banking services, may find it faces higher risks and takes longer to become financially sustainable than might be indicated simply by looking to the example of public banks in Germany, which benefit from stronger regional economies and from a governance model rooted

in strong regional and local governments. On the other hand, the UK market is much less competitive than these European counterparts, and significantly more profitable.⁸⁴

This means we cannot simply assume that models which work overseas will immediately work here: it may take time to embed these principles into UK banking. It also means that banking policy, including the establishment of a Post Bank, needs to go hand in hand with Labour's wider agenda of promoting regional economic development and financial inclusion, from community wealth building and political devolution to labour market policies designed to reduce poverty, inequality and over-indebtedness. Over time, these policies should complement and reinforce each other in shifting the UK economy towards a more regionally balanced, socially just and sustainable path.

3.2 Key features of successful national investment banks

National Investment Banksⁱ (NIB) have long played a key role financing and directing investment in many countries around the world.⁸⁵ Their fundamental role is to promote public policy objectives by influencing the volume and direction of investment in the economy. While the traditional functions of NIBs have been in infrastructure investment and counter-cyclical lending, in recent times they have taken on more active roles as key agents of industrial and innovation policy. In countries such as Germany and China, NIBs have taken centre stage in confronting the key social and environmental challenges of the 21st century, such as climate change.⁸⁶

In this section, we draw on academic literature and evidence from other countries to identify the key design features of successful NIBs around the world.

3.2.1 Mandate

A key reason why NIBs can be powerful agents of economic transformation is that they traditionally execute their roles in coordination with governmental policies. Most do this by focusing lending on areas that have been prioritised

ⁱ The terms 'national investment bank', 'national development bank', 'national promotional bank' and 'state investment bank' are often used interchangeably. In this report we use the term 'national investment bank', consistent with the Labour Party's proposals.

through industrial policy, targeting investments against the grain of market signals in order to drive structural transformation.

Most NIBs have their mandated sphere of activities set out clearly in law or in their Articles of Association, and it is common for these mandates to change and evolve over time. While some NIBs are given a narrow mandate which explicitly refers to the sectors, type of customers or activities that a NIB is expected to support, many of the more successful NIBs have broader mandates that enable them to support a wider range of economic objectives and respond to emerging priorities.⁸⁷

There is a growing consensus that NIBs that are 'mission driven', with investment activities guided by specific missions aligned with industrial policy, tend to be more effective than those which are focused on more neutral economic objectives such as promoting 'growth' or 'competitiveness'.⁸⁸ Although presented differently in each case, the mandates of leading NIBs such as the KfW, BNDES, European Investment Bank and China Development Bank are all linked to overcoming specific economic, social and environmental challenges. This enables them to play a leading strategic role in their respective economies. In contrast, the mandate of Italy's Cassa Depositi e Prestiti's is more static, focusing on 'economic development' and 'competitiveness' without signalling a desired direction for the economy, and this is reflected in its more inertial activities.⁸⁹

3.2.2 Ownership and institutional arrangements

By definition, NIBs are majority public-owned. In some cases, ownership lies wholly with the central or federal government, while in other cases ownership is shared with local or regional governments. Germany's KfW, which is widely regarded as one of the most successful NIBs, is 80% owned by the Federal Republic of Germany, and the remaining 20% owned by the German Federal States or 'Länder'.⁹⁰

In cases where NIBs are not 100% publicly owned, ownership is shared with private investors. However, there is evidence that part-private ownership can create pressure to deliver short-term returns, thus reducing the attractiveness of investing in higher-risk and longer-term areas. For example, Cassa Depositi e Prestiti is a joint-stock company which is 82.8% owned by the Italian Ministry of Economy and Finance, 15.9% owned by 60 banking foundations, and 1.3% owned by the Italian Treasury. As a joint stock company, the CDP has to give priority to profitability of its investments, and some studies have suggested that this impacts CDP's investment patterns, given that CDP's lending is mostly directed at supporting lower risk, established businesses rather than higher-risk, transformational investments.⁹¹

Among larger NIBs, it is also common to have multiple different operational arms which focus on different types of investment (e.g. business, infrastructure etc). An example of this is shown in Figure 6 (please see next page), which shows the organisational structure of Germany's KfW.

Three divisions are responsible for promoting investments in the German domestic economy. The 'SME Bank and Private Clients' ('Mittelstandsbank & Private Kunden') invests in small-and-medium sized enterprises, business start-ups and other commercial clients in Germany. Its provision of long-term finance at favourable rates contributes to maintaining the competitiveness and future viability of the German economy and creating and safeguarding jobs. The 'Customised Finance & Public Clients' (Individualfinanzierung & Öffentliche Kunden) oversees KfW's housing programmes, energy efficiency and other investments in environmental and climate protection, as well as financing for public investments in infrastructure projects and urban modernisation.

In June 2017 KfW also announced that a new venture capital subsidiary will be launched to substantially expand KfW's activities in the field of equity finance. This new subsidiary will improve the venture capital offering for innovative technology-oriented enterprises in the start-up and capital-intensive early growth phase.⁹²

Figure 6 KfW functional divisions



Source: KfW⁹³

The other three divisions have an international orientation: the KfW IPEX-Bank is the export-import leg of KfW, promoting internationalisation of German companies and structuring finance for selected projects; the KfW Development Bank provides finance for governments and other governmental institutions in developing and emerging countries; and the KfW DEG (Deutsche Investitions- und Entwicklungsgesellschaft) provides finance for private companies in developing countries and emerging economies. In 2013, KfW established a foundation, the KfW Stiftung, which is responsible for promoting initiatives related to major societal challenges.

A key difference between NIBs and private financial institutions is the breadth of expertise and capacities contained within staff. In many cases, such as KfW and the European Investment Bank, this includes not only financial expertise but significant in-house engineering and scientific knowledge about the sectors the bank is active in and the nature of the investments being made. This enables investment decisions to be based on a wider set of criteria than relying on market signals alone, and means they are better placed to appraise social and environmental considerations. In some cases staff are drawn on to provide expert advice on government policy design and implementation, as well as financing.⁹⁴

3.2.3 Governance

Governance arrangements are particularly important for NIBs. On the one hand, it is their distinct governance that enable them to play a fundamentally different role in the economy compared to that of private financial institutions. This is because NIB governance arrangements typically do not create pressure to deliver short-term returns, meaning that they can provide financing over a longer time horizon and prioritise wider social and environmental objectives. However, many of the problems that have commonly been associated with NIBs, such as weak performance, financial problems, unfair competition with the private sector, corruption and capture by interest groups, can be attributed to poor governance.

In particular, achieving the right balance between political representation and independent decision making is a key challenge. While political representation can help to maintain alignment with government policy and maintain a path of democratic accountability, steps should be taken to prevent undue political interference or capture by interest groups.⁹⁵ It is important that management teams are free to make sound, long-term decisions in line with the NIB's mandate, free of day-to-day political interference. Some NIBs achieve this by appointing independent,

non-political representatives on the most senior decision-making body.

The experience of KfW and Finnvera in Finland indicates that the idea of including a wider range of stakeholders such as industrial trade bodies, trade unions and regional representatives can be beneficial. The KfW Board of Supervisory Directors, which is the supreme decision making body, comprises:⁹⁶

- the Federal Minister of Finance and the Federal Minister for Economic Affairs and Energy, who act as chairman and deputy chairman, alternating the roles on an annual basis;
- five other specified federal government ministers;
- seven members appointed by the Federal Council (Bundesrat);
- seven members appointed by the Federal Parliament (Bundestag);
- one representative each of the mortgage banks, the savings banks, the cooperative banks, the commercial banks, and a credit institution prominent in the field of business credit;
- two representatives of industry and one representative each of the municipalities, agriculture, the crafts, trade, and the housing industry;
- four representatives of the trade unions.

3.2.4 Investment activities

The investment activities of NIBs typically vary between countries according to the bank's mandate, socio-economic circumstances and the country's stage of development. Mazzucato and Penna describe four different roles that NIBs typically play in their respective economies:⁹⁷

- **Countercyclical role:** In playing a countercyclical role NIBs direct finance towards productive opportunities throughout the swings of business cycles, providing a counterbalance to the pro-cyclical private financial sector. After the outbreak of the global financial crisis in 2007, many NIBs across the world played a significant counter-cyclical role, increasing their loan portfolio by 36% on average between 2007 and 2009, with some increasing their loans by more than 100%.⁹⁸
- **Capital development role:** The key role of many NIBs is to provide finance to enhance business competitiveness and help firms

grow in regional, national and international markets, and to finance public goods such as infrastructure. This might also include promoting strategic trade (such as export finance, import substitution, securing sources of materials), prioritising investments in existing strategic sectors (reinforcing comparative advantages) and creating 'national champions' that are able to compete in international markets.

- **Venture capitalist role:** A NIB's venture capital role involves providing the long-term, patient finance for innovative firms and start-ups that the private sector is often unwilling to provide. This involves creating and shaping new technological and industrial landscapes by acting as 'investor of first resort' in high-risk ventures.⁹⁹
- **Mission-oriented role:** A mission-oriented role involves pro-actively steering investments towards areas that address key societal challenges. This means going beyond 'fixing' market failures or 'levelling the playing field', and instead 'tilting' the playing field by making strategic investments that address certain 'missions'. These might relate to areas like inequality, climate change, or the challenges of an ageing population.¹⁰⁰

While throughout history the traditional roles played by NIBs have been basic capital development and counter-cyclical lending during a recession, over time a number of NIBs have also taken on venture capitalist and mission-oriented roles. In countries like China, Germany and Brazil, NIBs have taken centre stage in confronting the key social and environmental challenges of the 21st century.¹⁰¹ By steering investment towards overcoming key challenges, these banks are not just correcting 'market failures'; they are actively creating and shaping markets and steering the direction of economic activity.

For example, while initially KfW's lending focused on the reconstruction of post-war Germany, today all investments must contribute to at least one of three pre-established missions, or 'megatrends':¹⁰²

- **Climate change and the environment:** KfW finances measures to support renewable energy, improve energy efficiency, safeguard biodiversity and prevent and/or reduce environmental pollution. To address the special importance of this area, KfW has set an environmental commitment ratio of 35% of total promotional business volume. The

KfW has played an instrumental role in the systemic greening of the German economy through the Energiewende policy, which aims to combat climate change, phase-out nuclear power, improve energy security by substituting imported fossil fuel with renewable sources, and increase energy efficiency. The KfW 'Energy Transition Action Plan' was launched in 2011 and had invested over €100 billion by the end of 2016.

- **Globalisation and technological progress:** KfW contributes to strengthening the international competitiveness of German companies by granting loans in the following areas, among others: research and innovation, projects to secure Germany's supply of raw materials, and infrastructure and transport.
- **Demographic change:** KfW's objective is to address the consequences that result from a declining and aging population, including the following focus areas: age-appropriate infrastructure, vocational and further training, family policy and childcare as well as corporate succession.

3.2.5 Relationship with the wider financial sector

An important issue relates to how NIBs interact with the wider financial sector. While some NIBs lend directly to customers (particularly in the case of larger investments), many lend using the 'on-lending' model. This is where the NIB does not lend to customers directly, but instead provides discounted funding to private financial sector intermediaries, such as commercial banks (and in the case of equity investments, to private equity funds), who in turn on-lend money to customers. This model works by transferring low public borrowing costs to banks in order to make lending to certain types of activities more attractive.

The on-lending model is widely used for lending to SMEs by NIBs such as KfW, the European Investment Bank and the Nordic Investment Bank, and offers a range of benefits. Most significantly, it enables the NIB to utilise the existing branch networks and capacity of private sector intermediaries, allowing fast implementation at scale.

However, the on-lending model is subject to a number of limitations which may constrain the ability of the NIB to play a transformational role if adopted in the UK. Firstly, because money is fungible, the on-lending model means that it is

difficult to demonstrate that intermediaries have used the money in the intended manner. The intermediary may simply declare certain loans to be funded by the NIB, even if it would still have provided these loans without the NIB funding, and even if NIB support was actually used for other purposes. This is potentially problematic, as the on-lending model effectively provides a subsidy to private sector intermediaries in the hope that they will use this to support certain desired activities (e.g. SME lending). If this is difficult to monitor in practice, then NIB funding may end up promoting undesirable activities (e.g. supporting other types of lending, or increasing shareholder dividends)

Furthermore, the transmission mechanism of the on-lending model is similar in nature to the Funding for Lending (FLS) scheme, which was introduced by the Bank of England in 2012 to try and stimulate lending to households and businesses. Under the FLS scheme, banks and building societies were allowed to borrow from the Bank of England at cheap rates, and it was hoped that this would increase the availability of business loans and mortgages.¹⁰³ However, the impact that Funding for Lending had was mixed – bank lending to businesses did not increase much, while fears that the scheme was fuelling unsustainable mortgage lending led to it being scaled back in 2013.¹⁰⁴ Finally, using the on-lending model may make it more difficult for the NIB to lend counter-cyclically, as private banks tend to cut back on lending during downturns, and may not be willing to on-lend during times when it is needed most.

Many of these problems are less problematic in countries like Germany, where the KfW uses the on-lending model for SME lending, because the retail banking sector is largely made up of public and cooperative banks. These banks have a public interest mandate and tend to focus more of their lending on the real economy, and because they are not shareholder owned, the funding cannot be used to support shareholder dividends. But in the UK context, where the retail banking sector is currently dominated by five large shareholder owned banks (who already receive a significant 'too-big-to-fail subsidy'), relying on the on-lending model may severely limit the effectiveness of NIB interventions.

There is therefore an opportunity to use the NIB as a tool for promoting wider structural change in the financial sector – for example by using on-lending as a tool to the growth of banks with desirable characteristics to be promoted (e.g. the Post Bank).

3.2.6 Financial instruments

The primary activity of NIBs is the deployment of repayable financial instruments (such as debt and equity). Although NIBs are typically not profit maximising, they must manage a balance sheet and thus ensure that they are investing prudently. This means that the projects it invests in must be 'bankable' – i.e. they must be expected to generate future revenue streams that can be used to repay the finance. The NIB should therefore not be viewed as a replacement or substitute for government spending.

In order to fulfil a broad mandate NIBs typically have a wide range of financial instruments at their disposal, including both debt and equity, suited to different areas of the risk landscape. For example, equity investments may be suitable for higher-risk innovative enterprises, while debt instruments such as long-term loans may be better for lower-risk, incremental activities. This enables them to invest across the business lifecycle, from the start-up phase all the way through to providing long-term patient capital for established firms. Financing is typically provided at more favourable terms than private providers, as NIBs tend to have a lower cost of capital which in turn can be passed onto borrowers. This can come in the form of lower interest rates, longer loan horizons, or a combination of the two.

Some NIBs create programmes that target particular issues, many of which help address key societal challenges. These programmes offer loans to customers which meet certain criteria, often with advantageous terms. In addition to lending operations, many NIBs offer advisory services such as strategic planning, capacity building, and training programs help to create bankable projects that otherwise would not happen.

3.2.7 Financing

There are many different ways that NIBs can fund their investments, including raising money in the domestic or international capital markets, borrowing from other financial institutions, using return on investments, receiving budget allocations from the Treasury, managing public

pension or social security funds, or endogenously through money creation. Most NIBs are not deposit-taking institutions, and therefore do not typically engage in money-creation when making loans (i.e. their lending does not create new bank deposits as is the case with deposit-taking commercial banks¹⁰⁵).

The evidence suggests that sources of finance can have an impact on the ability of NIBs to successfully meet their mandates, and the most appropriate source of financing will vary depending on country specific circumstances.¹⁰⁶ Here a number of factors should be considered. First, sources of finance must be stable and available on the scale required to meet the desired level of investment. If a source of finance proves to be volatile or unstable, or vulnerable to political pressures, then it can seriously impair the ability of the NIB to fulfil its mandate.

The case of Brazil's BNDES is a case in point: following the impeachment of former president Dilma Rousseff in July 2016, a new government was formed and appointed a new leadership team at BNDES and implemented a new strategy. BNDES was asked to make an unanticipated repayment of the money it had borrowed from the National Treasury, starting with an R\$ 100 billion (US\$ 30 billion) in December 2016. This transfer, comprised of RS\$ 40 billion in securities and RS\$ 60 billion in cash, was justified by a political desire to reduce Brazil's overall national debt. This early payment was equivalent to 19% of the total amount that BNDES owes the Treasury, and over 120% of the bank's disbursements in 2016.¹⁰⁷

A second consideration is whether different sources of finance may affect a NIB's appetite for risk, and ability to invest in higher-risk but potentially higher impact projects. There is some evidence that sources of funding which draw heavily on household savings – such as postal savings in the case of Italy's Cassa di Risparmio di Venezia – create political pressure to minimise risk taking and thus reduce investment in radical innovation.¹⁰⁸ Similarly, an over-reliance on capital markets may lead to lending decisions being influenced by the methodologies used by rating agencies to assign credit ratings.

4 THE POST BANK: ANALYSIS AND RECOMMENDATIONS

The idea of a Post Bank has been around for centuries. But in recent decades, the increasing use of digital communication technologies has forced postal operators to rethink their overall business strategy and to diversify product offerings. As a result, many postal operators have decided to leverage their brand and branch network and provide a greater range of financial services. Today, out of a global adult population of approximately 5.4 billion people worldwide, 1.5 billion – or 28% – have access to some form of financial service through a postal operator. Among these, 1 billion people – or 19% of the world's adults – hold a current or savings account with a post office.¹⁰⁹

The UK also has a long tradition of postal banking. The UK established the first ever postal savings bank in 1861, and in 1968 the UK government launched Girobank – a new bank run by the Post Office offering simple and cheap basic banking services mainly for people without a bank account, which in the mid-1960s amounted to 75% of the adult population.¹¹⁰ Girobank was privatised in 1990, but during its existence it was widely credited for shaking up the UK banking market, forcing competitors to innovate and respond to the needs of the mass market.

Today some of the most successful examples of Post Banks include:

- **Japan Post Bank:** Established in 2006 as part of the reorganisation of Japan Post, Japan Post Bank offers financial services mainly for individuals through a network comprising 234 branches and about 24,000 post offices across the country.¹¹¹
- **La Banque Postale:** Established in 2006 as a subsidiary of La Poste, the French postal service. Since its establishment La Banque Postale has aggregated a number of specialisations in retail banking activities, insurance and asset management.
- **Kiwibank:** Established in 2002, Kiwibank is a subsidiary of New Zealand Post Limited. Kiwibank provides a range of banking services through post offices and its own branches.

These and several other examples from around the world show that postal banks can be a successful and innovative player in the banking sector, capitalising on core assets such as a strong brand and extensive branch network.

In addition to the general benefits that stakeholder banking could bring to the UK, as outlined in section 4, a new Post Bank would be well placed to deliver a number of additional benefits:

- **Promoting financial inclusion:** Multiple recent studies have shown that Post Banks are comparatively better than traditional financial institutions at providing financial services accounts to individuals who are most likely to be financially excluded such as the poor, less educated, and those out of the labour force.¹¹²
¹¹³
- **Rebuilding trust in banking:** The public perception of banks in the UK is very negative compared to other sectors. The global financial crisis, together with the ongoing excesses and scandals, has led to heightened mistrust towards banks. In contrast, the Post Office is generally held in very high regard by the public. A recent survey showed that the Post Office is the second most trusted brand by the British people.¹¹⁴
- **Maintaining basic branch banking as a public utility:** Many customers rely on their local branch for banking services. However, as commercial banks are rapidly withdrawing from the high street, these customers are at risk of being excluded from the financial system.¹¹⁵ Given that the Post Office's branch network is needed for postal services, the marginal cost associated with branches for a Post Bank is much smaller than for commercial banks. Moreover, many businesses visit the Post Office for cash or mailing services, so a Post Bank would be well placed to attract new customers.
- **Promoting positive behavioural change in the banking sector:** The UK banking sector has been hit by repeated scandals, with SME customers in particular suffering appalling

mistreatment. Direct provisioning of basic financial services by a Post Bank to households and businesses can act as a powerful tool to set a floor in the market and enforce a minimum level of consumer service and protection. Additionally, competition from Post Bank products would help to create a deterrent for abusive products in the market by acting as a market anchor and serving as a point of comparison for more complex products.¹¹⁶

- **Putting the Post Office on a sustainable financial footing:** If a Post Bank is able to become financially sustainable, this should eliminate the need for an ongoing annual subsidy for the Post Office and put it on a sustainable footing for the future.

In the following sections, we outline a series of recommendations relating to the design of the Post Bank.¹¹⁷

4.1 Institutional arrangements and business model

Around the world postal banks have adopted various institutional arrangements, ranging from complete integration within the post office, to full separation between the postal and the financial services entities. According to the Universal Postal Union, postal operators around the world typically adopt one or a combination of the following arrangements.¹¹⁸

- **Full integration:** this is where the postal financial services entity is a department or a directorate of the postal operator. The top management of the postal operator oversees both the financial and the non-financial services, and processes are very much integrated. This is the most common model encountered in the postal sector, with 76% of postal operators using it to provide financial services. However, it should be noted that very few of these operate as fully fledged banks, and instead offer only a limited range of financial services such as cash handling, payments and savings.
- **Subsidiary:** this is where the entity offering financial services is spun off from the entity offering other postal services to give it more independence and flexibility. The financial services entity remains a part of the postal group but has its own management and separate accounting. Service-level agreements

are often established between the entity operating the network and the entity offering the financial services. Most of the time, the postal staff and the postal branches belong to the entity offering the physical postal services (mail, parcels, etc.) and the financial services entity pays a certain amount to use this network. This model is not particularly common but is becoming more so, with almost 12% of postal operators now using it, compared to less than 10% four years ago.¹¹⁹

- **Dispersion:** this model is a hybrid between the previous two models. Some postal operators have decided to separate their financial services offering into a separate legal entity, and establish service-level agreements with the entity offering the financial services.
- **Joint-venture:** this is where the postal operator establishes a joint-venture with a bank or regulated financial institution to offer financial services through the postal network.

At present, financial services are currently provided through the Post Office via Post Office Money, which provides a range of products and services including mortgagors, credit cards, insurance and currency services to customers through Post Office branches and online under a 'joint-venture' model with the Bank of Ireland and other commercial partners. These partners are as follows:

- **Banking:** in 2004 the Post Office launched a joint venture with the Bank of Ireland (Midasgrange Ltd). In 2012, the Bank of Ireland bought out the Post Office's share of this joint venture for £3 million and moved to a contractual relationship between the two organisations that runs until 2023. Under the new agreement, the Bank of Ireland is responsible for product development and delivery while the Post Office has the primary responsibility for product sales and marketing and ensuring all customer interactions meet the Post Office's brand values. In addition, the Post Office has also partnered with J.P. Morgan Europe Ltd to offer a Post Office card account which is designed especially for people without a bank account.
- **Insurance:** the Post Office recently bought out the Bank of Ireland UK's stake in its joint insurance partnership and incorporated it into its subsidiary, Post Office Management Services Limited, which operates the business alongside its existing travel insurance activities.

- **Currency services:** the Post Office has a joint venture with the Bank of Ireland, called First Rate Exchange Services Holdings Limited, which supplies foreign exchange in the UK.

However, it is widely acknowledged that the partnership with the Bank of Ireland UK is no longer fit for purpose.¹²⁰ Bank of Ireland UK is in the process of winding down its Great Britain Business Banking and corporate banking businesses, and still suffers from legacy problems relating to the financial crisis. Moreover, it is not taking proactive steps to devise innovative new products and stave off competition from new challenger banks – in fact, on 11th March 2019 the Post Office announced that following a review by the Bank of Ireland, it would be closing down all of its Post Office Money current accounts and withdrawing this product completely.

Under the current partnership model, the ability of the Post Office to maximise the potential of its assets to deliver growth in financial services is reliant on the capabilities and willingness of the partner. But it is clear that Bank of Ireland UK is not well placed to deliver growth and expansion in the UK, meaning that the Post Office is not meeting its potential in financial services.

Moreover, Bank of Ireland UK is a large, shareholder owned bank that faces similar incentives to the UK's other large banks. As such, it is not able to address the problems of the UK banking sector, as outlined in section 3. Given that the Post Office is a public asset, it is important that its financial services offered through its brand and network serve the public interest. The partnership with the Bank of Ireland therefore resembles a missed opportunity to drive positive change in the UK banking sector.

We therefore **recommend that the partnership with the Bank of Ireland UK should be ended, and a new Post Bank should be set up** with a separate management team and separate accounting, and endowed with its own capital. In order to address the structural problems of the UK's banking sector that were identified in section 3, we consider that the Post Bank must be established as a fully-fledged bank with a formal banking license and the ability to extend credit.

We also **recommend that the new Post Bank is set up in a decentralised structure**, with lending and decision making devolved to sub-entities focusing on specific geographies. As outlined in section 3.1 there is strong evidence that banks

with a strong local focus maintain intimate knowledge of local people and the local economy, and are better than commercial banks at seeking and assimilating the 'soft' information needed to holistically assess the prospects of firms. Often described as 'relationship banking', this approach ameliorates the information asymmetry which makes SME lending unattractive to larger banks, where the drive for process efficiency and control leads to centralised systems of credit scoring that become blind to regional, local and firm specific conditions.

By having units that only lend in their local area, locally focused banks also create wealth regionally rather than reinforcing existing geographic lending imbalances. This contributes to increased access to finance in areas which are poorly served by commercial banks – particularly relevant to the current UK context as commercial banks are rapidly withdrawing from rural areas. This is also important in the context of an industrial strategy aimed at rebalancing the UK's extreme regional inequalities. In the absence of a devolved structure in which regional units are obliged to focus on lending within their home region, a nationally-focussed bank would be likely to 'cherry pick' the most profitable business in the most profitable regions, reinforcing rather than reducing regional imbalances.

While some level of decentralisation is clearly desirable: the question is what form this should take. Here the two key design issues are the legal and functional structure of the decentralised bank, and the geographic scale at which activities are decentralised.

4.1.1 Legal and functional structure

Some successful public banks, such as the German Sparkassen, operate as a network of legally separate local banks which manage their own separate balance sheets, but which achieve economies of scale by the pooling of certain central functions (such as IT and back office support) and by operating a mutual guarantee fund that shares risk among member banks.

Other locally focused banks, such as Sweden's Handelsbanken, employ a model of decentralisation that does not involve legal separation. This involves structuring the bank around the principles of subsidiarity (i.e. devolving decision making as close to the customer as possible) and accounting separation between devolved entities.

CASE STUDY: THE GERMAN SPARKASSEN

The Sparkassen are a network of public savings banks that operate across Germany. There are a total of 396 Sparkassen in Germany, which is equivalent to one bank per 210,000 people.¹²¹ Sparkassen have a 37% share of the retail banking market, and a 28% market share in lending to local businesses.¹²²

The Sparkassen have a public service mandate, but are not controlled by the local or national government. The public service mandate is enshrined within the German savings bank sector by federal and state laws that set out the requirements for using the 'Sparkasse' name. This includes promoting savings and financial inclusion, laying out what can be done with profits, and a focus on supporting SMEs. The activities that savings banks cannot engage in, such as proprietary trading in financial markets, are also laid out in state savings banks laws. Each bank incorporates its social mission explicitly in its own articles of association. Crucially, the Sparkassen operate according to the 'regional principle', whereby each Sparkasse must only lend within a defined regional area.

The Sparkassen are 'public law institutions', which is a legal category that does not exist in UK law. However, it is similar to trust ownership, in that the institutions have trustees (usually the local municipalities) but the capital is unowned. The ownership structure was chosen to protect the banks from investors buying them and diverting them from their social mandates. While municipalities are typically trustees, they have no power to sell the bank or distribute profits. Furthermore, municipalities are not the only trustees, with other local stakeholders sitting on the supervisory boards. This board is charged with ensuring the bank fulfils its public mandate, as laid out in the applicable state savings bank act.

The Sparkassen operate as a network, sharing ICT and back office costs and operating a Savings Banks Guarantee Fund that shares risk among its members. This means that if a savings bank gets into trouble, it can apply to the guarantee fund for access for financial support, thus mutualising risk across the ensure network.

CASE STUDY: HANDELSBANKEN

Handelsbanken is a Swedish bank that is renowned for its decentralised way of working and strong local presence. Handelsbanken's geographical structure ensures that decision-making is strictly decentralised to the local branch. Every branch of Handelsbanken is led by a manager who is responsible for all operations in his or her branch's local area of operations. Branch managers staff and organise their branches according to the business that the branch chooses to do in its local market. In most cases, the branch manager also lives in the local town and is very much involved in the community in which she or he works, giving valuable knowledge of the local market.¹²³

The local branch makes all credit decisions for customers in its geographical area of operations. When there are a sufficient number of branches in a larger geographical area, Handelsbanken establishes a regional bank. This contains joint administrative resources, regional expertise and specialists to support the branches' business. Handelsbanken's UK operations divided into 5 regional banks, and each regional bank is led by a head of regional bank. Each regional bank is monitored as an independent profit centre, has its own board and all income and expenses are allocated to the individual local branches. However, it is not strictly speaking an independent bank but rather an operational unit of Handelsbanken, which remains a single bank. Handelsbanken has had the highest level of customer satisfaction in the British banking market for ten years in a row, according to the ESPI survey.¹²⁴

Creating a network of legally separate local banks may offer greater benefits in terms of financial system resilience. There is evidence that a more modular banking system, characterised by multiple smaller banks that are separate but linked in networks, can be more resilient to shocks than a system dominated by a smaller number of larger banks.¹²⁵ However, this must be balanced against the cost and practicalities of setting up a large number of independent banks. In places where such networks exist, such as Germany, these banks have been built up over many centuries and are embedded in a specific legal, economic and cultural environment. Without any recent history of such institutions in the UK, attempting to establish lots of separate banks at one time may prove impractical.

Moreover, as discussed in section 3.1, in a country that is as regionally unbalanced as the UK, a model of fully localised banking may end up exacerbating existing regional imbalances. This is because banks in more deprived areas will attract fewer deposits and would likely be less able to generate profits and expand, whereas banks in more prosperous areas would likely be more profitable.

We therefore **recommend that the Post Bank is established as a single legal entity, but is structured into a series of regional banks/offices** that have a high degree of independence. Each regional entity will be tasked with overseeing all Post Bank branches in a defined geographic area, and will be required to produce separate accounts and establish their own regional boards. A central headquarters should be established outside of London, which will be made responsible for providing central support services such as IT, marketing, regulatory compliance, access to the payments system and a treasury function.

This model, which combines **centralised funding with decentralised decision-making**, should allow for deposits in more prosperous regions to be used to back loans in more deprived regions, thus aiding regional rebalancing. However, achieving this means the Post Bank being given a strong mandate to promote regional rebalancing. Without this mandate, if funding is allocated

centrally and individual loans made on a purely commercial basis, it is likely to reinforce rather than reduce existing regional imbalances.

4.1.2 Geographic scale of decentralisation

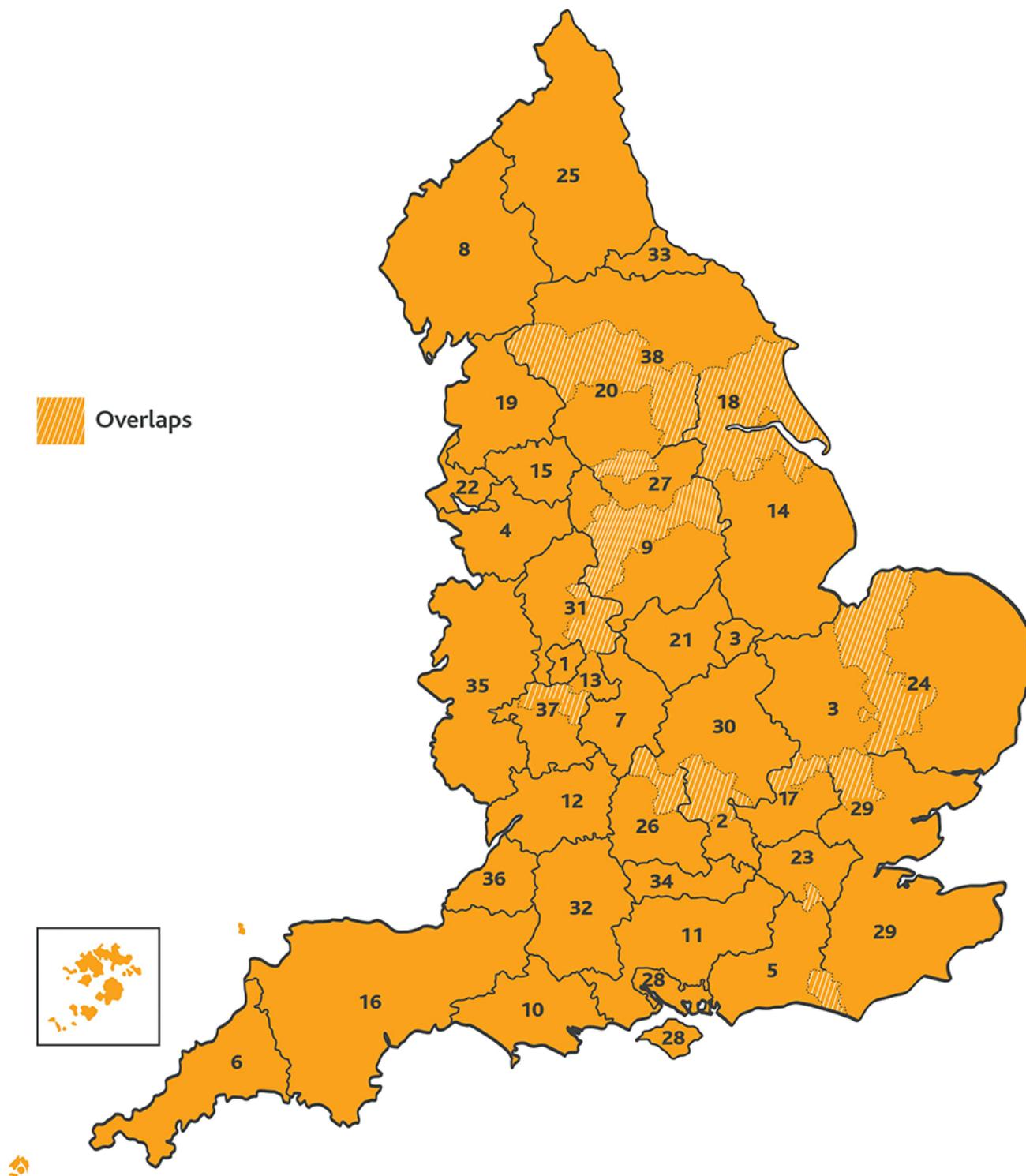
The scale of the decentralised units should be guided by three criteria. Firstly, each unit must be big enough to be practically viable, but not too big that they become detached from the needs of local communities. Second, they should be appropriately aligned with the local household and business markets (i.e. the places within each area should share common economic characteristics). Finally, the units should ideally be aligned with the approach taken to regional policymaking.

Given that this latter criteria is a devolved issue, we recommend that the degree of geographic decentralisation of the Post Bank within Scotland, Wales, and Northern Ireland should be a matter for the devolved administrations to decide. The following discussion relates to what an appropriate level of decentralisation is for the Post Bank in England.

One potential basis for determining the degree of geographic decentralisation is to organise the Post Bank regionally, with a different sub-unit for each of the nine regions of England. However, with populations ranging from 3 million to 9 million, it is likely that these units would be too large to reap the benefits of locally focused banking in any case. There is also no clear alignment with regional policy. Until 2010 the Regional Development Agencies (RDAs) operated at this scale in England, however these were abolished by the coalition government in 2010.

Another option for determining the degree of geographic decentralisation is Local Enterprise Partnership (LEPs) areas. These local bodies were introduced in 2011 in replacement of the RDAs to help determine local economic priorities and lead economic growth and job creation within the local area. There are 38 LEPs areas across England, corresponding to one per 1.5 million people.

Figure 7 Map of Local Enterprise Partnerships (LEPs) across England



Source: LEP Network¹²⁶

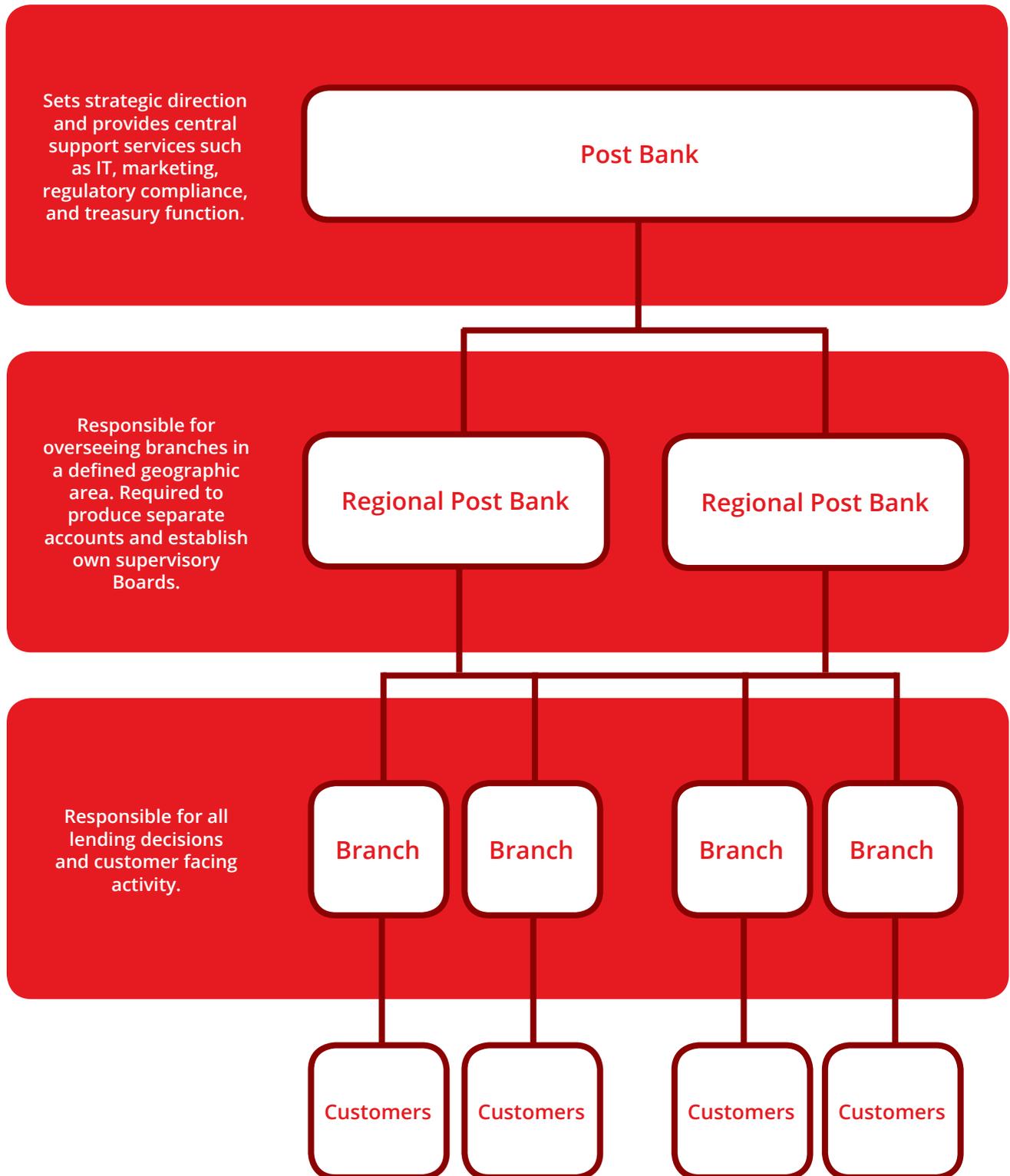
LEP areas therefore represent a more sensible scale for establishing the regional offices. Moreover, because LEPs are partnerships between local authorities and businesses, they are also better aligned with local business

markets and regional policymaking. However, Labour’s approach to regional policy is still under development, and it is not yet clear whether LEPs will continue under a Labour government. It is therefore important that the final decision

on the degree of geographic decentralisation is aligned with Labour's thinking in this area. The final decision should also be subject to significant consultation to give relevant stakeholders an

opportunity to feed into the process. The overall organisational structure envisaged for the Post Bank is illustrated in Figure 8.

Figure 8 Structure of new Post Bank



Note: The Post Office's branch network is discussed further in section 4.5

4.2 Mandate

In order to reap the benefits that are associated with successful public banks elsewhere as described in section 3.1, it is important that the Post Bank is given an explicit public service mandate. This will ensure that the Post Bank helps to address the problems with the UK's banking sector that were identified in section 3, in addition to making a financial return.

In Germany, the public service mandate is enshrined within the German savings bank sector by federal and state laws that set out the requirements for using the 'Sparkasse' name. This includes objectives such as promoting savings and financial inclusion, laying out what can be done with profits, and a focus on supporting SMEs. The activities that savings banks cannot engage in, such as proprietary trading in financial markets, are also laid out in state savings banks laws. In addition, each bank incorporates its social mission explicitly in its own articles of association.

In light of this, **we recommend that the new Post Bank is given a public service mandate**, enshrined in primary legislation and its Articles of Association, to provide financial services according to the following principles:¹²⁷

- to provide access to basic retail banking services to all citizens regardless of income, wealth, or social status;
- to restrict its activities to basic retail banking servicesⁱⁱ, travel and currency services, and insurance;
- to provide access to financial products on fair and affordable terms;
- to support SMEs, social enterprise and public enterprise through the provision of appropriate financial products and services, including advice;
- to promote positive attitudes to saving and to advance financial literacy;
- to manage the bank's capital prudently;
- to contribute positively to the financial sustainability of the Post Office network; and

- to manage any profits in line with the bank's profit sharing obligations (discussed further below in the 'financial considerations' section).

In addition, regional banks/offices will be required to adhere to the following principles:

- to restrict its activities to the geographic region in which the regional bank is domiciled;
- to conduct business so as to promote inclusive social and economic development in the geographic area of operation.

These requirements should be set out in primary legislation establishing the Post Bank, along with the devolved regional structure, to ensure that these are durable aspects of the Bank's model rather than subject to changes of management.

4.3 Ownership and governance

As outlined in section 3.1, a key reason why stakeholder banks deliver better outcomes than shareholder-owned banks is their ownership and governance structures. These arrangements will be particularly important for the Post Bank, given its dual objective of meeting public interest objectives and providing a financial return to the Post Office.

International experience suggests that careful safeguards will need to be built into the bank's ownership and governance model to ensure it remains focussed on its public mandate. Failing to do this could result in the bank being pressured to take excessive risks or cut costs in order to maximise profits, which could repeat many of the mistakes we have seen with our private banking sector and undermine the long-term sustainability of the Post Bank – as well as its ability to provide the Post Office with a steady and reliable income stream. There are many examples from around the world where public banks have been pressured to deliver short-term returns, with disastrous consequences.

4.3.1 Ownership

Options for the ownership of the Post Bank should be assessed against four key criteria. Firstly, the ownership arrangements must ensure

ⁱⁱ We recognise that there are many different definitions of what constitutes 'basic retail banking services'. For the purposes of the Post Bank, we recommend that basic retail banking services correspond to those activities that can be carried out within ring-fenced entities, as defined in the Financial Services Banking Reform Act 2013. These include retail and small business deposit-taking; deposit-taking activities for large corporates; lending to individuals and corporates; transactions with central banks; trade finance; and payment services.

that the Post Bank is able to fulfil its public service mandate. Certain ownership models (for example, the private shareholder model) enshrine the supremacy of certain goals such as profit maximisation, and are therefore unsuitable for the Post Bank.

Secondly, the ownership arrangements must be able to provide the Post Office with a steady and reliable income stream, so that it can fulfil its mandate to contribute positively to the financial sustainability of the Post Office network. Importantly however, this does not need to be in the form of dividend payments conferred through outright ownership. Indeed, there are good reasons why relying on dividends may not provide the steady and reliable income stream that the Post Office requires. The profitability of banks can be volatile, and is often vulnerable to swings in the business cycle. We therefore consider that under any ownership model, the financial arrangements between the Post Bank and the Post Office should not be solely linked to profitability. Instead, the Post Bank should be required to pay a fixed 'access payment' to the Post Office each year, which would be sufficient to cover use of the Post Office's assets (branch network, brand etc) and ensure that the Post Office is placed on a sustainable financial footing. This access payment would be a fixed operating cost for the Post Bank, providing the steady and reliable income stream that the Post Office requires. The access payment would be calculated independently, and would be subject to review every three years.

Thirdly, we consider that the ownership and governance arrangements must ensure that the Post Office is not overly exposed to risks in the wider banking sector. One of the reasons given by the government for rejecting a proposal for the creation of a Post Bank by the Post Bank Coalition in 2009, and more recently in its response to the 2016 Post Office Network Consultation, was that it would introduce increased risk in the Post Office's balance sheet.^{128 129} While we do not endorse the government's assessment of the case for a Post Bank, we believe that it is important to consider the exposure of the Post Office to the risks in the banking sector. Ownership confers rights over the rewards of financial success; it also involves bearing the risk of financial failure. Banks can and do get into financial difficulties – sometimes due to circumstances beyond their control. While it will not be possible or desirable to completely eliminate exposure to these risks, we believe that it is desirable for the ownership and governance arrangements to limit this exposure within reasonable bounds.

Finally, it is important that the ownership model incorporates safeguards against future privatisation. History shows that Conservative governments move quickly to privatise any new public banks that are created whenever they get the opportunity to do so. Girobank, the last bank that was owned by the Post Office, was privatised by Margaret Thatcher in 1990, while the Industrial and Commercial Finance Corporation was privatised in 1994. More recently, the Conservative government privatised the Green Investment Bank, and is now moving ahead with plans to sell RBS back to the public sector. If the Post Bank is to be a durable institution, it is essential that safeguards against privatisation are introduced to avoid it suffering a similar fate. Below we assess a range of possible ownership models against these criteria.

Option 1: Wholly owned subsidiary of the Post Office

Under this model, the Post Bank would be established as a wholly owned subsidiary of the Post Office. While the Post Bank would be owned by the Post Office (and in turn the government), it would have autonomy to make decisions independently, free from day-to-day interference.

This was the model recommended by CASS Business School in the recent report, 'Making the Case for a Post Bank', and is the model used in other countries such as France and Japan. While this model should enable the Post Bank to fulfil its public service mandate and deliver a steady and reliable income stream to the Post Office, we consider that without additional safeguards it may leave the Post Office overly exposed to risks in the UK banking sector. As the ultimate owner of the Post Bank, the Post Office would be exposed to financial sector turbulence and liable for any financial losses.

More fundamentally, however, we consider that this option would mean that the Post Bank would be vulnerable to future privatisation. In other countries with successful postal banks such as France and Japan, positive attitudes towards public ownership are more culturally entrenched, therefore the risk of privatisation is less of a concern. However, if the Post Bank was established as a wholly owned subsidiary of the Post Office, a future Conservative government (as ultimate owner of the Post Bank) could privatise it relatively easily as happened with its forerunner, Girobank. As outlined above, Conservative governments have privatised most publicly owned banks that have existed in recent decades.

Option 2: State ownership

Another option would be to establish the Post Bank as a separate, state-owned bank that would establish a partnership agreement with the Post Office and pay an annual 'access payment', as outlined above. Under this model, the Post Bank would be established as a public financial corporation and owned by a department of the government, such as the Department for Business, Energy and Industrial Strategy (BEIS). Labour has proposed a similar model for the new publicly owned Regional Water Authorities that it plans to create following the nationalisation of the private water industry.¹³⁰

This model should enable the Post Bank to fulfil its public service mandate and deliver a steady and reliable income stream to the Post Office. It should also shield the Post Office from risks in the banking sector. However, state-ownership would mean that the Post Bank would be vulnerable to privatisation under a future Conservative government, as has been the case with other state owned banks.

There are also notable examples where state-owned retail banks have run into difficulties. For example, the German Landesbanken, which are owned by regional state governments, suffered considerable losses during the financial crisis following a reckless investment strategy. In the years preceding the crisis the Landesbanken stepped outside of their traditional expertise to invest in complicated, high-yielding financial products, such as mortgage-backed derivatives, which later turned out to be enormously over-valued. Many Landesbanken had to be bailed out by the federal government. In 2018, HSH Nordbank – one of Germany's seven Landesbanks – was sold to a consortium of US private equity groups led by Cerebrus, and another group of private equity investors are currently in the process of acquiring a stake in NordLB, another of the Landesbanken.^{131 132} These developments underline how vulnerable state-owned banks can be to privatisation and political interference.

Option 3: Cooperative or mutual ownership

As discussed in section 3.1, cooperative banks account for a significant proportion of the banking market in many European countries. They are owned and controlled by their members (usually their customers) on the basis of one vote per

person, rather than by shareholders, whose vote is proportional to their financial stake. Members invest a small amount of money in the cooperative to buy a share, which cannot then be traded among members or third parties. Furthermore, unlike shareholders in joint stock companies, cooperative members do not have any legal claim on the profits generated by the businesses, or any share in the appreciation in the value of the business. Cumulative profits are instead owned by the cooperative itself. Mutuals, such as building societies in the UK, are similar to cooperatives, although customers of mutuals automatically become members rather than choosing to and, unlike members of cooperatives, cannot usually run for election to the board.

Cooperative ownership would enable a steady and reliable income stream to be delivered to the Post Office, and would also shield the Post Office from wider risks in the banking sector. Cooperative ownership is a form of private ownership, however it would provide safeguards against full privatisation in the sense that a future Conservative government would not be able to turn it into a private, shareholder owned bank. Crucially, however, cooperative ownership would prevent the Post Bank from fulfilling its public service mandate. This is because cooperatives are legally required to operate for the benefit of their members, which would make alignment with a wider public service mandate difficult.

Option 4: Public trust ownership

An alternative approach would be to establish the Post Bank using the public trust model. Under a public trust model, there are no shareholders – instead ownership is held in a trust company (e.g. 'Post Bank Trust Limited') for the benefit of a defined purpose set out in its founding documents. Public trusts are governed by a Board of Trustees who are appointed to ensure that the assets held in the trust are being managed in line with its founding purpose. While the public trust model might seem novel for a UK bank, trustee banks have a long tradition in the UK through the Trustee Savings Bank movement.¹³³ The public trust model is also similar to that adopted by public interest banks in other countries, such as the German Sparkassen. Unlike the state-owned German Landesbanken, the Sparkassen proved resilient throughout the financial crisis and did not get into financial difficulties.¹³⁴

Table 1 Assessment of different ownership models

	Subsidiary of the Post Office	State-ownership	Cooperative / mutual	Public trust ownership
Public service mandate	✓	✓	X	✓
Provides Post Office with steady income	✓	✓	✓	✓
Limits financial exposure of Post Office	X	✓	✓	✓
Safeguards against privatisation	X	X	✓	✓

When a bank is run as a public trust its capital is in essence unowned. Nobody has a legal claim on the bank's capital, making it inherently hard to sell. While public bodies (e.g. central governments or local municipal authorities) are typically appointed as trustees, they have no power to sell the bank. Privatisation is not impossible, but is much more difficult as doing so would require an Act of Parliament to change the terms of an asset that it did not own, which would be significantly more controversial than a government legislating to dispose of state-owned assets. Furthermore, public representatives typically sit alongside other stakeholders on the Board of Trustees (e.g. employees, customers, industry representatives). In the case of the Post Bank, the Board of Trustees would be charged with ensuring the bank fulfils its public service mandate that would be set out in primary legislation, as discussed in section 4.2.

Table 1 summarises our assessment of the different ownership models against criteria set out at the beginning of this section. On balance, we consider that the public trust model best fulfils these criteria. It enables the Post Bank to fulfil its public service mandate; it provides the Post Office with a steady and reliable income stream via the annual 'access payment'; it ensures that the Post Office is not exposed to undue risk in the banking sector; and it secures the long-term sustainability of the bank by providing safeguards against future privatisation.

We therefore recommend that the Post Bank should be established under a public trust model whereby ownership is held in trust for the public benefit. A comprehensive and legally binding services agreement should be established between the Post Bank and the Post Office, which would set out the relationship between the two entities with regards to issues such as branch

access, the access payment, branding, etc. This is consistent with the 'dispersion' model discussed in section 4.1.

4.3.2 Governance

Under the public trust model, the Board of Trustees is charged with ensuring the bank fulfils its public service mandate. In order to be successful, it is important that the Board of Trustees includes a broad range of stakeholders that give voice to the bank's public service mandate. However, it is important that no single stakeholder is able to exert undue influence over decisions.

We therefore recommend that the Board of Trustees is structured along tri-partite lines, with the following three groups of stakeholders represented:

- 1. Public representatives** – One-third of the Trustees should be reserved for public and political representatives chosen to represent the broad public interest. This should include a UK government minister (likely from the Department for Business, Energy and Industrial Strategy), a Scottish Government minister, a Welsh Government minister, a Northern Ireland Executive minister – as well as the Chair of the Post Office. There should also be some spaces reserved for elected representatives that are not serving in government and are not members of the ruling political parties, in order to prevent domination by a single political constituency. The restriction of political representation to one-third of the Board of Trustees prevents the likelihood of undue political interference in the bank's lending decisions, over which the Board of Trustees in any case has no jurisdiction.

2. Regional Banks – One-third of the Trustees should be nominated by the Boards of the Regional Banks, which will also be structured along tri-partite lines to include local elected representatives (e.g. local authority councillors), employees and representatives from other key local stakeholders, such as local chambers of commerce, social enterprises and charities. This ensures that there is a degree of accountability to local communities, and also ensures that regional banks are able to hold the central management to account, as well as the other way around.

3. Other national stakeholders – The final third of the Trustees should comprise representatives from other key national stakeholders, including staff, small business and postmaster representatives.

The Trustees should be competent to exercise effective supervision over executives and, unlike Trustees of charities, Bank Trustees should be paid for their time and offered appropriate financial and management training, as is the case for members of the supervisory boards of German savings banks. These governance structures are consistent with the recent review that was commissioned by the Shadow Business Secretary and Shadow Chancellor of the Exchequer into corporate governance reform that was conducted independently by Professor Prem Sikka, Professor Alastair Hudson and others.¹³⁵

Our recommended governance structure for the Post Bank is summarised in Table 2.

Table 2 Proposed governance structure of the Post Bank

	Membership	Role
Post Bank Board of Trustees	One-third reserved for public representatives (including the Chair of the Post Office, BEIS minister, Scottish Government minister, Welsh government minister, Northern Ireland Executive minister). One-third to be nominated by the Boards of the Regional Banks. One-third comprising representatives from other key national stakeholders, including staff, small business and postmaster representatives.	Ensuring the bank fulfils its public service mandate, appointing senior executives, assessing the performance of the central group function and the Regional Post Banks – but explicitly prohibited from interfering with their day-to-day management and banking decisions.
Post Bank executive board	Post Bank senior management, composed of financial services professionals.	Running day-to-day management of the Post Bank central functions, and providing support to the Regional Post Bank teams.
Regional Bank supervisory boards	One-third to be nominated by elected local representatives (e.g. local authority councillors). One-third to be elected by the Regional Bank’s employees. One-third comprising representatives from other key local stakeholders, such as local chambers of commerce, social enterprises and charities.	Ensuring that the management of each Regional Bank is delivering against the public service mandate and the strategy set out by the Post Bank board. Strictly a supervisory role and explicitly prohibited from interfering with day-to-day management and banking decisions.
Regional Bank executive board	Senior management of each Regional Bank, composed of financial services professionals.	Overseeing day-to-day management of the Regional Post Bank, and providing support to branches

4.4 Financial products and services

According to the Universal Postal Union, postal operators around the world typically adopt one or a combination of the following business models for financial services:

- **Cash merchant:** this is where the post office acts as a cash-in/cash-out agent for one or various partners (money transfer operator, mobile money operator, government entity, utility company, financial institution, etc.)
- **Proprietary domestic and cross-border payments:** this is where the post office operates its own domestic payments and international remittance services.
- **Partnership with a financial services provider:** this is where the post office partners with a financial services provider, such as a bank or an insurance company, to offer the financial services of that partner. The main difference from the previous model is that the Post Office is not merely providing cash-in/cash-out services, but is much more involved in the provision of the services. Products can be developed jointly with the partner and adapted to the postal clientele. In many of such partnerships, the postal brand is used to sell financial products.
- **Postal savings bank:** this is where the post office offers its own insurance and/or account-based services (savings or current accounts), under a regulatory framework that is specific to the Post Bank. Usually in this model, the post office is not allowed to offer lending services or any other sophisticated financial products.
- **Full-fledged postal bank:** this is where the post office offers its own account-based services (savings or current accounts), but with a licence from the financial regulatory/supervisory authority.

The proposed model for the Post Bank combines the third and fifth options, whereby a new Post Bank is established as a fully-fledged bank, but which operates as a legally separate entity in partnership with the Post Office, rather than as a subsidiary of it.

As mentioned above, the Post Office already provides financial services via Post Office Money and a partnership with Bank of Ireland UK:

- **Cash handling services:** Over the past year cash withdrawals in Post Office branches grew by approximately 6% over the year, while cash deposits, driven largely by small businesses, grew by 28% in the same period. The Post Office's ATM business also continues to perform well, supporting over 230 million transactions last year and dispensed £10 billion of cash.¹³⁶ The Post Office has described how it is rapidly becoming "a cash utility for the UK."¹³⁷
- **Financial services:** Bank of Ireland UK has an exclusive financial services partnership with the Post Office under a contract that currently covers the period until 2023. The Post Office is primarily responsible for sales performance and marketing, while the Bank of Ireland is responsible for product development, pricing and service delivery through the Post Office's 11,500 branches in the UK serving 2.4 million customers. Products offered include:
 - **Mortgages:** Bank of Ireland UK offers a range of fixed rate, tracker and first start mortgages under the Post Office brand. Residential mortgages amounted to £15.9 billion in 2018 – 80% of the Bank of Ireland UK's total outstanding loans.
 - **Current accounts and savings:** Bank of Ireland UK offers a wide range of current account, ISA and bond products under the Post Office brand. In 2018 there were £14.2 billion of deposits held in Post Office branded current accounts at Bank of Ireland UK.^{iii 138}
 - **Credit cards:** Bank of Ireland UK offers a variety of credit cards under the Post Office brand. Credit cards amounted to £564 million in 2018 – 3% of the Bank of Ireland UK's total outstanding loans.¹³⁹
 - **Personal loans:** Bank of Ireland UK offers personal loans for cars, home improvements and other needs under the Post Office brand. In 2018 personal loans amounted to £681 million – 3% of the Bank of Ireland UK's total outstanding loans.¹⁴⁰
- **Travel and currency services:** The Post Office has a joint venture with the Bank of Ireland, called First Rate Exchange Services Holdings Limited, whose principal activity is the supply

iii On 11th March 2019 the Post Office announced that following a review by the Bank of Ireland it would be closing down all of its Post Office Money current accounts and withdrawing this product completely from September 2019.

of foreign exchange in the UK. The Post Office owns 50% of First Rate Exchange Services Holdings Limited, which generated £34 million in dividends in 2018.

- **Insurance:** In 2015 the Post Office bought the joint insurance business from the Bank of Ireland (UK) plc and incorporated it into its subsidiary, Post Office Management Services Limited, which operates the business alongside its existing travel insurance activities. In 2017/18 insurance revenues were £48 million.

Together, these services accounted for £297 million (30%) of the Post Office's turnover in 2017/18, and have become a growing source of revenue in recent years.

We **recommend that all products and services currently offered through Post Office Money are transferred to the newly established Post Bank**. The partnership with the Bank of Ireland should be ended, and the **new Post Bank should seek to acquire the Bank of Ireland UK portfolio**, therefore retaining all the customers that have acquired banking products and services that are branded via Post Office Money. We also **recommend that the Post Bank explores options to acquire other assets and infrastructure from Bank of Ireland UK** that will accelerate the process for becoming fully operational, including staff.

The present arrangement with Bank of Ireland UK is not due to end until 2023, however if it is made clear that the agreement will not be getting renewed it may be possible to reach an agreement and acquire the portfolio before then. This approach should address concerns that it will be difficult for a Post Bank to gain market share in the UK's competitive banking landscape.

We recommend that upon being established, the Post Bank should seek to attract new customers and grow and expand its market share in the areas that it is already active in. However, we also **recommend that the Post Bank establishes a new business division focused on SME lending and business current accounts** (including social enterprises and charities). At present there are no business loan or bank account products offered under the Post Office brand – the Bank of Ireland UK is in the process of exiting from this market in order to comply with state aid conditions that were attached to the bailouts it received during the financial crisis. But this is an area of the

market that is currently being underserved by the present banking landscape.

As UK banks have become increasingly centralised and reliant on credit scoring algorithms in recent decades, skills relating to relationship-based SME lending have gradually been lost. As will be discussed further in section 7.3, training and skills development for loan officers at the local branch level, as well as for management at the regional and national headquarters, will be key. We recognise that developing the skills and expertise that will be required to grow market share in SME lending may take time. However, a Post Bank would be well placed to acquire customers in the SME market due to a number of key strengths:

- **Extensive branch network:** Small businesses value the presence of a branch network much more than other banking consumers, and there is evidence that branch closures have had a significant negative affect on SME lending.¹⁴¹ Given that the Post Office's branch network is needed for postal services, the marginal cost associated with branches for a Post Bank is much smaller than for commercial banks. Moreover, many businesses visit the Post Office for cash or mailing services, so a Post Bank would be well placed to attract new customers.
- **Distinct business model:** As outlined above, the UK banking sector's focus on short-term shareholder value means that SME lending is particularly unattractive as it contributes little to the rate of return on equity compared with mortgage lending and financial sector lending.^{142 143} Similarly, the reliance on centralised and automated credit-scoring techniques and the availability of collateral prevents many healthy firms from being able to borrow and invest. In contrast, the Post Bank's public ownership and public service mandate means that it can prioritise lending to businesses over the pressure to deliver short-term returns. Moreover, by de-risking lending through building up strong relationships and understanding the businesses it lends to rather than requiring collateral, it can unlock new segments of the business market. However, it is recognised that developing these skills and capabilities will require significant up-front investment, which should be made a strategic priority (see section 7.3).
- **Support from the National Investment Bank:** As will be discussed further in section 6, we recommend that the Post Bank becomes a primary partner for NIB on-lending. This will

mean that it will be well placed to attract new customers that wish to benefit from the NIB's favourable lending terms.

4.5 Customer interface

In order to attract customers and grow its market share, customers must be able to access Post Bank products and services through a range of different mediums.

4.5.1 Branches

Many customers, particularly small businesses, value the presence of a branch network.¹⁴⁴ At a time when many commercial banks are rapidly retreating from the high street, establishing a strong high-street presence will be key to the Post Bank's success. As previously noted, given that the Post Office's branch network is needed for postal services, the marginal cost associated with branches for a Post Bank is much smaller than for commercial banks, placing it at a competitive advantage. Moreover, many businesses visit the Post Office for cash or mailing services, so a Post Bank would be well placed to attract new customers.

At present there are a total of 11,592 Post Office branches across the UK. However, there are five different categories of branches, which vary widely in scale:¹⁴⁵

- **'Crown' branches:** These are the large 'flagship' branches that are directly managed by the Post Office. These branches typically have the most space (usually the whole shop is given over to the Post Office, rather than it sharing premises with another business) and many contain private areas that were previously used for financial services. These branches already offer a wide range of financial services such as the Post Office's ISA, growth bonds, reward saver and instant saver products, and will be suitable for branch banking with relatively little need for investment. There are currently 218 Crown branches across the UK.
- **Large branches:** These branches all have a dedicated and secure Post Office counter and several counter positions. These offer a range of currencies on demand as well as a wide range of financial services such as the Post

Office's ISA, growth bonds, reward saver and instant saver products. Many of these branches will be suitable for branch banking, however this will likely require new investment. There are currently 3,389 large branches across the UK.

- **Local branches:** These are small branches that do not have a dedicated counter position, but offer services at the normal till of a retailer (e.g. over the newsagents counter). These do provide cash services, but are unlikely to be suitable for branch banking. There are currently 3,779 local branches across the UK.
- **Traditional branches:** These are small 'last shop in the village' post offices in mainly rural areas. These do provide cash services, but are unlikely to be suitable for branch banking. There are currently 2,634 traditional branches across the UK.
- **Outreach branches:** These are temporary services which may only be provided out of a van one or two days a week, and are therefore unsuitable for branch banking. There are currently 1,572 outreach branches across the UK.

The geographic spread of these branches is presented in table 3.

We estimate that while all branches will be able to provide cash handling and currency services, only the 'Crown' and large branches will be able to offer the full suite of banking and financial services. However, this would still mean that the Post Bank would have the largest branch network among all UK banks by a considerable distance. We have not been able to obtain the more granular data needed to estimate the amount of investment that would be required to ensure that all large branches have the capacity to provide the full suite of banking services. But it is likely that all branches will require investment in furniture, equipment and IT and security systems to meet customer expectations and regulatory standards. Some branches may also require interior design work to create a more aesthetically pleasing environment for bank customers. We estimate that the level of investment will be in the range of at least £100 million, although recommend that identifying the precise investment need should be a priority for a future Labour government.

Table 3 Number of Post Office branches

Region	Crown	Large	Local	Traditional	Outreach	Total
East Midlands	7	258	277	204	143	889
East of England	14	285	355	311	150	1115
London	61	338	187	81		667
Northern Ireland	6	121	199	112	49	487
North East	6	148	167	88	77	486
North West	25	450	342	184	114	1115
Scotland	16	282	506	361	234	1399
South East	26	370	517	325	146	1384
South West	20	293	360	341	257	1271
Wales	10	169	305	241	190	915
West Midlands	7	346	271	186	98	908
Yorkshire and the Humber	20	329	293	200	114	956
Total	218	3,389	3,779	2,634	1,572	11,592

Source: UK Government¹⁴⁶

4.5.2 Business outreach

In order to successfully develop a business model of ‘relationship banking’, the Post Bank must be able to build up strong relationships with business customers. However, given that not all branches will be able to support in-house loan officers, we recommend that each regional Post Bank employs a number of mobile business loan officers who will travel to meet business customers at their offices. Customers will be able to arrange an appointment with a business loan officer over the phone or by visiting any local branch.

These officers should have intimate knowledge of local people and the local economy, and be experts at assimilating the ‘soft’ information needed to holistically assess the prospects of small firms. Such a facility will enable businesses located outside of urban centres to establish a close relationship with the Post Bank.

4.5.3 Telephone and digital

Customers should also be able to access Post Bank products and services over the phone and online. The latter will be particularly important to ensure that the Post Bank is able to attract younger customers. In some other countries, long-established public banks are viewed by young people especially as old-fashioned and behind the curve; the Post Office brand may

similarly be stronger with older generations. But a return to ‘old-fashioned’ relationship-based lending need not entail an old-fashioned approach to using technology. On the contrary, starting a new bank from scratch provides an opportunity to avoid many of the issues arising from incumbent banks’ decades-old legacy IT systems. It also provides the potential to be at the cutting edge of the fintech revolution. In order to maximise these opportunities, **we recommend that various options, including developing in-house capacity and partnering with a responsible fintech firm**, should be considered as part of ensuring that the new Post Bank is able to position itself at the forefront of the fintech revolution and is able to compete effectively in fast moving areas such as mobile apps and debit cards.

4.5.4 Banking Framework Agreement

Following the establishment of the Banking Framework Agreement in January 2017, customers of 28 high street banks are now able to carry out their everyday banking at one of the Post Office’s branches. These services include deposits, withdrawals, change, and cheques and balance enquiries.¹⁴⁷ Part of the rationale for the Agreement was the recognition that many commercial banks are withdrawing from the high street – a process that has been motivated by a desire to cut costs and increase profits.

While we recognise the important role that the Banking Framework Agreement has played, we believe that it is a second best solution to this problem. Widespread branch closures are a symptom of a banking sector that serves private shareholders over the public interest. The Banking Framework Agreement only provides customers with access to very basic banking services (deposits, withdrawals etc) and leaves many communities without access to lending services, which has been particularly challenging for small businesses. With the establishment of a fully-fledged Post Bank that will offer a comprehensive range of banking services in every community, we consider that the Agreement would be rendered unnecessary. However, we acknowledge that ending the Agreement would not necessarily be the best way forward, therefore we recommend that it should be reviewed periodically.

As commercial banks continue to withdraw from communities, we recommend that a Labour government should consider how their legacy assets could be used to support the Post Bank, for example through branch transfers. This is discussed more fully in section 7.1.

4.5.5 Open Banking

In 2016 the final report of the Competition and Markets Authority's (CMA) retail banking market investigation required large banks to allow their customers to share their own bank data securely with third parties under the so-called 'Open Banking' standard.¹⁴⁸ 'Open Banking' enables customers them to manage their accounts with multiple providers through a digital app, to take more control of their funds and to compare products on the basis of their own requirements. The report also required banks to send out suitable periodic and event-based 'prompts' such as on the closure of a local branch or an increase in charges, to remind their customers to review whether they are getting the best value and switch banks if not.

These demand-side solutions that focus on increasing customer engagement, improving transparency and making better information available to customers are welcome. However, on their own they do little to affect customers' underlying motives to engage or to switch in the first place. With the market dominated by a small number of large, universal, shareholder-owned banks who all behave in similar ways (and who have been hit by repeated scandals), it is hardly surprising that today there is weak customer engagement and switching activity.¹⁴⁹ Instead,

genuine competition and choice requires a diversity of providers for consumers to choose from.

The Open Banking reforms should therefore provide a good opportunity for the Post Bank to attract new customers and grow market share. As will be discussed further in section 4.6, the Post Bank's unique business model means that it should be able to offer lower interest rates on loans and higher interest rates on deposits rather its commercial competitors. As such, its products should compare favourably on Open Banking's product comparison tools. Similarly, the fact that banks must now send out periodic 'prompts' to customers regarding events such as the closure of a local branch will serve to benefit the Post Bank given its strong commitment to branch based banking.

4.6 Financial considerations

In this section, we firstly consider the current financial performance of the Post Office, and then examine the capitalisation and funding needs of the Post Bank, and examine its profitability potential.

4.6.1 Current financial performance of the Post Office

In 2017/18 the Post Office reported a trading profit of £35 million, an increase of £22 million since 2016/17, which was the first year the Post Office reported a profit in 16 years.^{150 151}

However, the trading profit measure does not include Network Subsidy Payments or investment funding. The Network Subsidy Payment is designed to cover the operating costs of the network and ensure that branches which are not profitable are able to stay open. In 2010 the government announced that the Network Subsidy Payment would "fall substantially over time", and since then it has fallen dramatically – from over £200 million in 2013/14 to just £70 million in 2017/18. The Post Office would not have been able to report a trading profit without this government subsidy.

In 2017, the government pledged £370 million of funding for the Post Office network from April 2018 to March 2021.¹⁵² Of that funding £210 million will be invested in continuing to modernise the branch network, and the remaining £160 million will be used as the Network Subsidy Payment to protect rural branches.

The Post Office's revenue in 2017/18 was £1,031 million. Revenues can be broken down by the individual products and services that the Post Office provides. Over the past five years the Post Office has seen declining revenues from government services (-39.6%) and mails and retail (-7.3%).

The combination of falling government subsidies and falling revenues from many business activities highlights the need for revenue diversification.

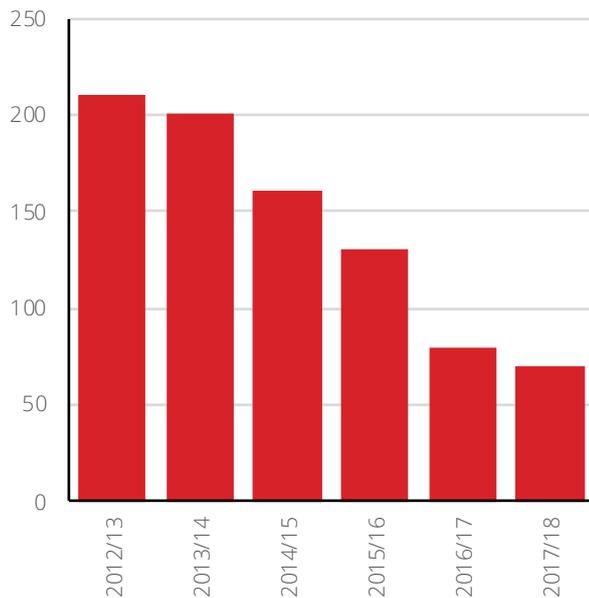
4.6.2 Capitalisation and funding of the Post Bank

Banks are required to hold capital to cover potential losses, which mainly consists of common shares (also known as common equity) and retained earnings. Taken together, these 'own funds' are equivalent to the difference between the value of total assets and liabilities. A bank with insufficient capital can easily go bust if it suffers large losses.

Global rules on bank capital are shaped by the Basel Committee on Banking Supervision, which issues the Basel Accords standards for banks' prudential capital requirements for banks globally. These regulations mean that banks are required to hold a minimum level of capital as a proportion of their assets. The amount of capital a bank is required to hold depends on the bank's total assets and the risk weighting of these assets, which in turn depends on the risk profile of the underlying loans. Following the financial crisis, banks are now required to hold more capital than previously, which should enable them to absorb some or all of their losses more readily in the event of a crisis.

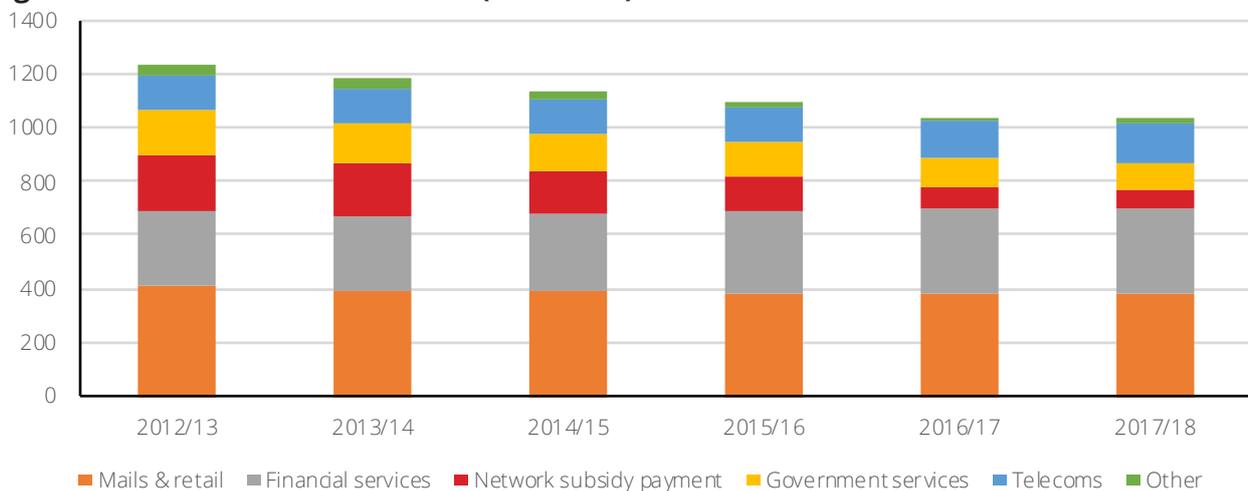
The initial capitalisation of the Post Bank must be sufficient to finance the acquisition of the Bank of Ireland UK portfolio, and support a balance sheet of this scale in line with regulatory capital requirements. Bank of Ireland UK's current book equity is around £2 billion.¹⁵⁴ Its leverage ratio (defined as Tier 1 capital divided by a total assets) is 6.6%, which is far higher than the 3% minimum required by the Prudential Regulatory Authority (PRA), and higher than most major UK banks (as shown in figure 11).

Figure 9 Network subsidy payment (£ millions)



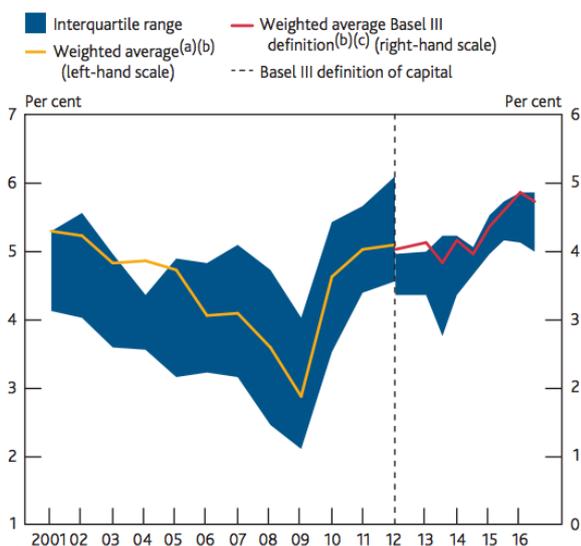
Source: House of Commons Library¹⁵³

Figure 10 Post Office revenues (£ millions)



Source: House of Commons Library¹⁵⁵

Figure 11 Major UK banks' leverage ratios



Source: Bank of England¹⁵⁶

Assuming that Bank of Ireland UK's market value will be roughly similar to its book equity, an initial capital injection of £2 billion should be sufficient to enable the Post Bank to finance the acquisition of Bank of Ireland UK, and support healthy capital adequacy ratios in line with regulatory requirements. However, in light of the plans for growth and expansion, particularly in the SME market, the Post Bank would require additional capital to support a growing balance sheet and investment in the branch network. Overall, based on the scenarios for growth discussed below, we estimate that the Post Bank **will require an initial £2.5 billion of capitalisation from HM Treasury.**

Given the current low interest rate environment, the HM Treasury could issue long-term bonds to finance this equity. The current interest rate for 10-year British Government gilts is less than 2%. This means that issuing debt to finance the set-up of a Post Bank would not be expensive, and the interest payments would be cheaper than continuing to subsidise the Post Office at current levels into the future.¹⁵⁷ Although the government would still be providing an effective subsidy in the form of non-dividend paying capital, this can be justified on public policy grounds just as the Network Subsidy Payment presently is (i.e. because there are uses of the

Post Office's network that are socially valued but not profitable).

The majority of the Post Bank's funding will come from retail deposits, including from personal current accounts, business current accounts, and savings products. As noted above, there are already £13.9 billion of deposits held in Post Office branded current accounts at Bank of Ireland UK. We recommend that a small amount of the Post Bank's funding should also come from debt issued to financial markets of varying maturities. Part of this debt could also be offered to retail investors looking for a secure long-term investment.

Responsibility for managing the bank's assets and liabilities, and meeting regulatory requirements, will lie with the bank's central treasury function. However, as noted in section 3.1, there have been examples where public banks have got into financial difficulties because the treasury function came under pressure to invest in riskier assets in order to boost profitability. In order to avoid this from happening, we recommend that restrictions are placed on the Post Bank's treasury function to ensure that it remains focussed on supporting retail banking services to households and businesses, and does not over-reach into other, riskier or less socially useful types of activity.

4.6.3 Profitability

A key issue relates to whether the proposed model will enable the Post Bank to operate profitably. As with all non-commercial banks there is a potential tension between the Post Bank's public service mandate and its profit making potential. This is because the mandate instructs the Post Bank to serve customers that are excluded from the traditional financial sector, often because they are deemed to be unprofitable by profit-oriented banks.

However, as outlined above, the Post Bank's public ownership and partnership with the Post Office means that it will have certain cost advantages over commercial banks. In addition, the Post Bank would inherit a range of profitable activities that are already undertaken by Bank of Ireland UK and Post Office Money, which means it would start from a strong financial position. In 2018 Bank of Ireland UK made a profit of £173 million based on the balance sheet summarised in Figure 12.¹⁵⁸

Figure 12 Bank of Ireland UK plc – balance sheet in 2018

Assets	£m	Liabilities	£m
Cash and balances with CBs	2,567	Deposits from banks	3,152
Loans and advances to banks	2,348	Post Office branded deposits	14,237
Loans to customers:		Other customer deposits	5,532
Residential mortgages	15,880	Subordinated liabilities	290
SME and corporate	1,320	Total other liabilities	1,485
Commercial property	502	Total equity	2,004
Consumer	2,133		
Financial assets	–		
Total other assets	1,167		
Total assets	26,700	Total liabilities	26,700

Source: Bank of Ireland¹⁵⁹

In addition, the cash, travel and insurance products currently provided by Post Office Money also contribute significantly to the profitability of the Post Office. The Post Office does not provide a detailed breakdown of how profitable each of these activities are, but the Post Office’s joint venture for the supply of foreign exchange (First Rate Exchange Services Holdings Limited) generated £35m in dividends in 2017/2018.¹⁶⁰

It is therefore clear that, while there may be certain activities undertaken by the Post Bank that will not be particularly profitable, overall the Post Bank should be able to generate a profit in aggregate. We take the Bank of Ireland’s profit of £173 million to be a rough estimate of the initial ‘baseline’ profits that the Post Bank would be able to make, although as noted above this is likely a conservative estimate since it does not include profits from the cash, travel and insurance products currently provided by Post Office Money.

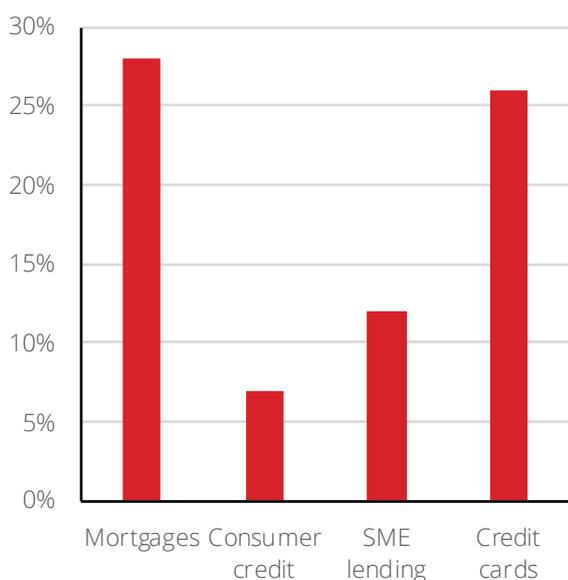
However, as outlined in section 4.3, we recommend that the Post Bank should be required to pay a fixed ‘access payment’ to the Post Office each year that is sufficient to cover use of the Post Office’s assets and put it on a sustainable financial footing. This access payment would be a fixed operating cost that must be paid before profits are reported. The access payment would be calculated independently and could replace the network subsidy payment to the Post Office from the Government (which stood at £70m in 2017/18).

It is clear that the Post Bank could operate profitably even if the access payment was set relatively high. For the purposes of our financial projections here we assume that the access payment would initially be set at a level equivalent to the income the Post Office currently receives from its partnership with the Bank of Ireland UK, which is already accounted for in the £173 million ‘baseline’ profits. With a higher access payment, this estimate would need to be adjusted.

An important question relates to what should happen to any surplus profits incurred. We recommend that any profits should be retained within the business and used to enhance the bank’s capital position, with the benefits passed onto customers. In the absence of the need to pay dividends, the Post Bank will have a lower cost of capital than its commercial rivals, which should enable it to offer lower interest rates on loans and higher interest rates on deposits. This in turn should help the Post Bank gain a competitive advantage and grow its market share.

We also recommend that a small proportion of any profits should be used to fund local charitable or community initiatives, as is the case with the German Sparkassen. Doing this would help integrate the Post Bank into local communities and build popular support for the bank.

Figure 13 Return on equity by banking product



Source: Credit Suisse¹⁶¹

Looking ahead, the Post Bank’s future profitability depends on its ability to grow and expand in existing and new markets. As figure 13 shows, some products and services are considerably more profitable than others. On the basis of contribution to return on equity, Credit Suisse has calculated that mortgages are the most profitable lending product, followed by credit cards, with SME lending and consumer credit having lower returns.¹⁶²

As outlined in section 5.4 we recommend that growing market share in the SME lending and business current account (BCA) market should be a key priority for the Post Bank. As is clear from the balance sheet shown in figure 12, Bank of Ireland UK’s existing SME portfolio is small and shrinking. This is because the bank was forced to exit its Great Britain Business Banking and corporate banking businesses in response to state aid conditions attached to the bailout it received during the financial crisis, and is gradually winding down its operations in this area.

However, SME lending – if done properly – can be a profitable activity, and succeeding in this market will be key if the Post Bank is to meet its public service mandate. The Post Bank should be well placed to acquire customers in this market due to its extensive branch network and the fact that many businesses already visit the Post Office for cash or mailing services.

According to the final report of the recent CMA Retail Banking Investigation, there are currently around 5.5 million business current accounts (BCAs) in Great Britain – a figure that has been broadly stable since 2012.¹⁶³ Smaller SMEs (with annual turnover below £2 million) account for the vast majority of BCAs held – over 90% in 2014. The BCA market is currently very concentrated: according to the CMA, the four largest banking groups have an 80% market share.

A total of £21 billion worth of business loans (including commercial mortgages, but excluding residential property loans) were granted in the UK in 2015, with an average loan value of £237,496. The total stock of outstanding balances at year end 2015 stood at approximately £96 billion, consisting of approximately 580,000 loans. Smaller SMEs accounted for around three-quarters of new loans granted in the UK by volume but less than half the value of these loans. Approximately two-thirds of business loan revenues from interest and charges were earned on loans to SMEs with annual turnover less than £2 million.

According to the CMA, the main drivers for BCA profitability are “number of active customers, level of fees charged for BCA usage; level of credit balances; income from overdraft fees and interest; and net interest margin”.¹⁶⁴ The same report goes on to say that:

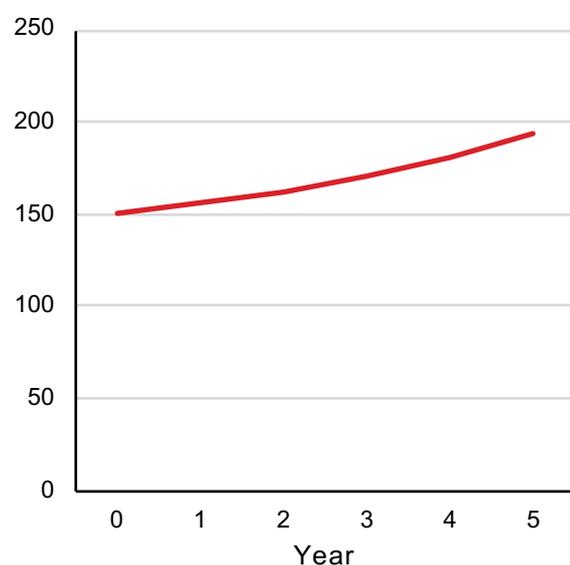
“Larger SMEs are the most profitable as they tend to hold higher credit balances, have higher transaction volumes and a need for a broader range of banking products and services. Charities, clubs and societies on the other hand are the least profitable SMEs for banks as they usually get ‘free’ transactional banking, are likely to have lower credit balances and are more likely to use cheques, which are more costly for banks to process.”

This is likely to be important for the Post Bank given that its public service mandate will require it to support social and public enterprises, as well as private firms. We suggest that as an initial target, the Post Bank should aim to acquire a 5% market share in the SME market. This would equate to roughly 275,000 business current accounts, and a business loan portfolio of around £4.8 billion. We consider this to be a realistic target for the Post Bank given its extensive branch network and support it will receive from the NIB. As noted in section 4.4, we recognise that developing the skills and expertise required to grow market share in SME lending will take time.

Table 4 Financial projections of the Post Bank's SME division

Year	0	1	2	3	4	5
Loan balances (£m)	1320.0	1676.4	2129.0	2703.9	3433.9	4361.1
Spread (%)	3.1%	3.1%	3.1%	3.1%	3.1%	3.1%
Net interest income (£m)	40.5	51.5	65.4	83.0	105.4	133.9
Non-interest income as % of loans	1.9%	1.9%	1.9%	1.9%	1.9%	1.9%
Non-interest income (£m)	25.1	31.9	40.5	51.4	65.2	82.9
Core banking income (£m)	65.6	83.3	105.8	134.4	170.7	216.7
Cost/income ratio (%)	49.1%	49.1%	49.1%	49.1%	49.1%	49.1%
Costs (£m)	-32.2	-40.9	-52.0	-66.0	-83.8	-106.4
Net operating income	33.4	42.4	53.9	68.4	86.9	110.3
Provisions as a % of loans	0.85%	0.85%	0.85%	0.85%	0.85%	0.85%
Provisions (£m)	-11.2	-14.2	-18.1	-23.0	-29.2	-37.1
Pre-tax profit (£m)	22.2	28.2	35.8	45.4	57.7	73.3

Note: This model assumes that in year 0 the Post Bank starts with the Bank of Ireland UK's SME portfolio, which was £1,320 million in 2018. Assumptions on income, costs and provisions have been made with reference to actual figures from the UK retail banking sector, using a database compiled by Credit Suisse.¹⁶⁵

Figure 14 Projected profitability of the Post Bank (£ million)

In table 4, we present a set of financial projects for the Post Bank's SME activities which assume for illustrative purposes that this target is met within five years. Using conservative assumptions to reflect the Post Bank's public service mandate, we estimate that acquiring a 5% market share in the SME market would generate around £73 million

of profit. Combining this with the estimate of the initial 'baseline' profits that the Post Bank would make from the activities inherited from the Bank of Ireland UK and Post Office Money, we present a projection of the Post Bank's future profitability in Figure 14. We consider that this is an extremely conservative estimate, because it assumes that the Post Bank does not expand its market share in the mortgage lending, consumer lending, travel and currency services and insurance markets.

4.7 Regulatory considerations and state aid

Banks and building societies are regulated under both UK and European legislation. The Financial Services Act 2012 introduced a new regulatory framework for financial services in the UK. Under this framework, the Bank of England is responsible for financial and monetary policy and for the safety and soundness of banks and other financial institutions. The PRA, which is part of the Bank of England, is responsible for the prudential regulation of banks including the authorisation of deposit-taking activities. The FCA, which replaced the Financial Services Authority on 1 April 2013, regulates the conduct of banks and building societies.¹⁶⁶

In addition to these bodies, a number of European and international bodies also regulate UK banks and building societies, although the future of this is uncertain in light of the Brexit vote. These include the European Banking Authority, which ensures effective and consistent prudential regulation and supervision across the EU banking sector, and the Basel Committee on Banking Supervision, which issues the Basel Accords setting suggested standards for banks' prudential capital requirements which must then be legislated for by each nation (or by EU regulation).

The Post Bank would need to apply for a banking licence to the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA), which can take up to 12 months. When authorising a bank, the PRA and the FCA must ensure that the applicant firm will currently satisfy, and will continue to satisfy, the Threshold Conditions for which each regulator is responsible. These include consideration of the following matters:

- Viability of the business plan;
- Capital and liquidity;
- Governance arrangements (including ownership, legal structure and management);
- Risk management and controls;
- Resolvability of the applicant firm (for example, how easy it would be to put the bank into bankruptcy or restructuring while inflicting the minimal damage possible on the rest of the UK financial system).

In addition, as long as the UK remains part of the EU, or has a comprehensive trade agreement with the EU, it is likely that all bodies will have to comply with EU state aid rules. State aid rules prevent governments from providing financial support that could distort competition and affect trade by favouring certain undertakings or the production of certain goods. Support has to pass four tests for it to count as state aid:¹⁶⁷

1. It has to be granted by the state or through state resources which can take a variety of forms (e.g. grants, interest and tax reliefs, guarantees, government holdings of all or part of a company, or providing goods and services on preferential terms, etc.)
2. It has to confer a selective advantage to an undertaking, for example to specific companies

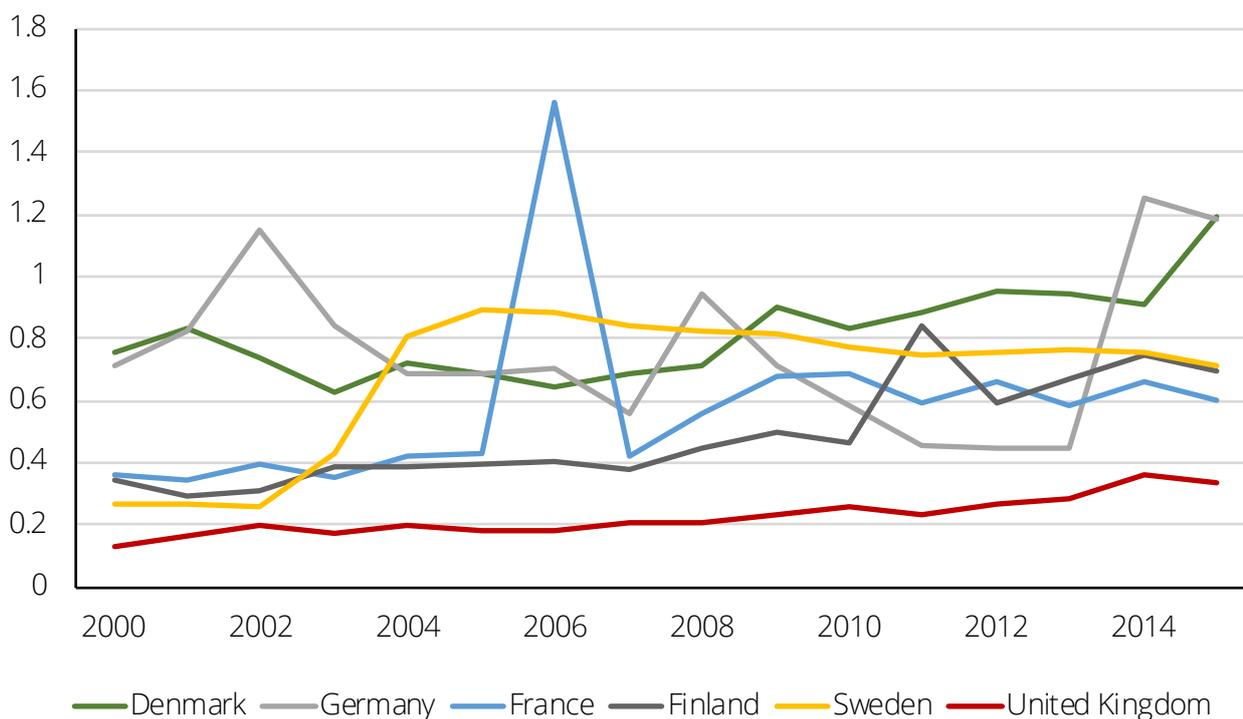
or industry sectors, or to companies located in specific regions.

3. It has to distort or have the potential to distort competition – i.e. strengthen the beneficiary relative to competitors.
4. It has to affect trade between member states – in practice, to affect any market where the goods or services are tradable between member states.

In many instances state aid will not arise because no advantage is conferred and the above state aid criteria are not met. An important example is the Market Economy Operator Principle (MEOP), which occurs when an investment or loan is made by a public-sector body on a purely commercial basis. In order to apply the MEOP and for the investment to fall outside the remit of state aid, the investment or loan must be at genuinely commercial rates, on the same terms and with the same risks and rewards that a commercial private investor or lender would invest or lend at. There are also certain categories of aid which are exempt from the requirement to notify state aid to the European Commission. The first of these is the 'De Minimis Regulation', which sets a threshold figure below which state aid will not apply because it will be assumed that the aid will not distort competition. Below this limit, the European Commission does not need to be notified of any investments made. Current rules stipulate that the total de minimis aid granted to any one organisation must not exceed €200,000 over any period of three fiscal years.

If a proposed investment is above the de minimis limit, the next step is to assess whether it falls within the scope of the General Block Exemption Regulation (GBER). These exemptions outline the areas in which State aid investment is allowable due to EU social, development or growth policies and include areas like support for environmental protection, SMEs and start-ups, research and development and regional aid. For interventions that do not fall within de minimis limits or a block exemption regulation, an ex-ante analysis of the market failure to be addressed is required before state aid will be granted. As shown in figure 15 below, the UK has consistently spent less on State aid expenditure relative to other northern European countries, suggesting that UK policymakers have taken an overly cautious approach in the past.

Figure 15 Total state aid expenditure as a % of GDP in 2015



Source: European Commission¹⁶⁸

Overall the Post Bank should not encounter difficulties getting state aid clearance. Many of its activities will be conducted on a commercial basis, while the activities that are not conducted on a commercial basis should be exempt under the de minimis limits or a block exemption regulation

for specific market failures. It is recommended that the Post Bank engages with other European postal banks, such as France’s La Banque Postale, to learn how to navigate the state aid regime most effectively.

5 RBS: ANALYSIS AND RECOMMENDATIONS

In 2008 the UK government bailed out RBS at a cost of £45 billion, giving the taxpayer an 80% stake in the bank. No conditions were attached to this sale, and it has never been the policy either of the Brown government or subsequent Conservative-led governments to reform the bank or to use it as a public asset. However, numerous proposals have been made over the years to do just that, including by think tanks across the spectrum from the New Economics Foundation to Civitas. RBS is one of the UK's largest banks and the government's shareholding could give it control over a substantial piece of our banking system, and with it a potentially powerful lever for change. Any future Labour government must ask itself how best to use this opportunity.

The first element to consider will be the shareholding, if any, that a future Labour government inherits. The size of this future shareholding is open to considerable uncertainty. It is the Conservative government's stated intention to continue with share sales regardless of the loss that is realised, but a prolonged and precipitous fall in the share price coupled with the chaos around Brexit are likely to sorely test this plan. The first question facing an incoming Labour government will be whether to buy or sell, all or some, of the remaining shares, by judging the cost / proceeds against alternative uses for the money.

Any proposals must also consider how RBS fits into a strategy for the whole financial system, and two elements in particular are worth noting. First, how RBS could fit with the role proposed for the Post Bank and the National Investment Bank. This should be set in a broader strategy for a diverse ecosystem of financial institutions. Labour must also consider here the investment of government time and attention, given the likely significant operational and cultural challenges involved in reforming RBS. Second, the usefulness of a stake in RBS in light of the wider regulatory changes that we must assume Labour are likely to introduce, including making offshore activities and tax avoidance more difficult, tackling too big to fail, limiting speculative financial activities and incentivising lending that will contribute to a just transition.

In this section we first review the government's share sales to date, and how future Conservative government sales might develop. We then examine RBS's conduct and changed business model since 2008. Finally, we lay out a number of policy options and make a recommendation.

5.1 Government Share Sales

In November 2008 the government purchased 58% of ordinary shares of RBS together with a tranche of preference shares which were subsequently converted into ordinary shares (April 2009). In December 2009 the government purchased a further tranche of B shares taking total economic ownership to 84.4%. The total injection amounted to £45.5 billion. The purchase price of ordinary shares was 502p/share and the National Audit Office calculated a break-even sale price of 625p/share when taking into account the costs of financing the bailout.¹⁶⁹

As recently as 2015, George Osborne was insisting that the taxpayer would recoup UKFI's investment in RBS,¹⁷⁰ despite selling shares for a loss that year. In 2017, as the share price continued to fall, Hammond admitted the obvious: the whole stake might be sold at a loss.¹⁷¹ A further sale in 2018 bore this out. Indeed all sales so far have been well below the purchase price – crystallising a loss of over £3 billion. The share price has continued to fall since June and towards the end of December 2018 was around £2/share.¹⁷² The government has not specified a minimum price at which it will sell.

The first sale came in 2015. Despite significant public opposition, the government sold 630 million shares at a price of £3.38 each. Compared to the purchase price of £5.02 this crystallised a loss of £1 billion, while realising proceeds of £2.1 billion.^{173 174} Part of the given rationale for this initial sale was that it would trigger a rise in the share price by signalling a clear intention to reprivatize and reducing the 'overhang' associated with the government's large stake. However, this did not materialise, and further sales were put on hold after the Brexit vote caused the share price to collapse.

Figure 16 RBS Share price



Source: RBS¹⁷⁵

In the 2017 Autumn Statement, Philip Hammond announced the intention to recommence privatisation, with plans to reduce the government's stake by £15 billion over the next five years.¹⁷⁶ In June 2018, the government sold 925 million shares at £2.71 each, reducing its stake from 70.1% to 62.4% (a 7.7% reduction).¹⁷⁷ This raised £2.5 billion at an even bigger loss of £2.1 billion.^{178 179} Various commentators had suggested this was a bad time to sell, as problems in Spanish and Italian banks were further depressing bank share prices. RBS' own CFO, Ewan Stevenson, who departed in mysterious circumstances earlier in 2018, said just days before the share sale that it was "not the right time".¹⁸⁰ By the 2018 Autumn Budget reality was beginning to intrude on the government's rhetoric: "the government now intends to undertake a full disposal of the RBS shareholding by 2023-24, subject to market conditions and achieving value for money." It also admits that it "expects larger disposal values in later years".¹⁸¹

There are likely a number of reasons for why the government has been so keen to sell quickly at such a significant loss. First, the sales announced in the 2017 budget balanced the additional costs of the Help to Buy scheme and allowed the government to say that net debt would fall fractionally as a share of GDP.¹⁸² The OBR was

scathing about this approach, pointing out that asset sales do not improve the long term fiscal position and that RBS could be a source of long term revenues.¹⁸³ With the share price having partially bounced back from its initial post-Brexit low, the political calculation seems to have been that the benefits of being seen to stick to its debt reduction pledges outweighed the likely public opposition to a loss-making sale. Some have also speculated that the government sees the bank as a liability rather than an asset, and wants to offload this liability as quickly as possible. Finally, it is entirely possible that part of the motivation for a quick sale is to keep RBS out of the hands of a future Labour government.

As can be seen in Figure 16, the share price has continued to fall in 2018, with Brexit often given as a reason, and by mid December 2018 was approaching £2, reducing the value of the government's stake. It has since increased slightly at the beginning of 2019. The OBR estimated the stake to be worth £19.3 billion at 2017 prices generating a loss of £26.2 billion on the initial bailout (taking into account the costs of financing)¹⁸⁴ – 57.5% of the initial outlay. Table 5 below shows the value of the ordinary equity, the government's share and the remaining share at various prices. The table gives an insight as to how much could be raised by selling all the shares or

Table 5 Value of ordinary shares and govt stake at various prices

Share price (pence)	50	100	150	200	225	250	300	350
Total Equity value (£ billions)	6.0	12.0	18.0	24.1	27.1	30.1	36.1	42.1
Govt Share (£ billions)	3.8	7.5	11.3	15.0	16.9	18.8	22.5	26.3
Not Govt Share (£ billions)	2.3	4.5	6.8	9.0	10.2	11.3	13.6	15.8
Illustrative proceeds from sale to 51% (£ billions)	0.7	1.4	2.1	2.7	3.1	3.4	4.1	4.8
Loss on remaining govt. stake from £5.02 (£ billions)	-34.0	-30.2	-26.4	-22.7	-20.8	-18.9	-15.2	-11.4

the cost of buying back all the outstanding shares. We also show the illustrative proceeds of the government selling its current stake down to 51% at various prices. Finally, we show the loss that would be realised compared to a purchase price of £5.02 on the government's current stake.

Of course, the initial outlay is a sunk cost. The real question is whether a better deal for taxpayers and the economy could be achieved by taking a different course – or whether the long-term public policy benefits of keeping RBS in public ownership would justify foregoing some or all of the potential short-term proceeds from reprivatisation.

5.2 Potential future scenarios before a Labour government.

Before examining RBS policy options facing an incoming Labour government it is necessary to consider how future Conservative policy, particularly with regard to further share sales, might affect the government's shareholding before a general election.

If the government sticks to anything like its declared schedule of sales then the bank may well no longer be in majority public ownership, and therefore majority control, by the time a general election takes place in 2022. We have calculated a number of possible scenarios based on the government's declared plans and its share sales so far. As noted above in 2018 they aim to have completely liquidated their holding by 2023-24. Using the Autumn 2017 statement (£15 billion of disposal over 5 years) provides a scenario whereby the government's stake is reduced to 22% by 2023 (crystallising additional losses of £17.9 billion over four years compared to the break-even price calculated by the NAO).

Given 2018 sales are already behind this schedule however we can imagine a scenario with slightly slower disposals. Even this however puts the government stake at around 32% by 2023. If, instead, we assume that the plan is to sell off two-thirds of the stake over this period regardless of the price, then the decline is steeper but the point at which the stake drops below 50% remains roughly the same. In short, if a version of the government's plans come to pass then by the time of an election in 2022 we might expect the government stake in RBS to be between 33% and 40%, and almost certainly below 50%.

These scenarios however are exposed to considerable risk. There are various risks to the government's planned share sales such as an early election, changed circumstances around Brexit, a continued fall in the share price, etc. As the OBR points out: "As the Government's announcement makes clear, sales will be subject to value-for-money considerations and prevailing market conditions, so there will always be a risk that sales do not take place – as happened when the previous programme of sales was put on hold after the EU referendum last year."¹⁸⁵ In this case Labour could come to power with a stake much closer to 51%. If slightly below the cost of repurchasing would be relatively low, while any excess over 51% could be sold to raise funds while still retaining a majority shareholding.

The biggest potential barrier would be the potential effects of Brexit on the bank's share price. RBS CEO Ross McEwan has indicated that a disorderly Brexit could affect the bank's recovery and put pressure on its profits and share price. In the third quarter of 2018 RBS made a £100 million provision against "uncertain economic outlook" in light of Brexit.¹⁸⁶ It seems unlikely these Brexit considerations have been factored

into the Treasury's forecasts.¹⁸⁷ One person we spoke to suggested that a hard Brexit would halve the value of RBS, making a sale politically unlikely. Unresolved Brexit questions introduce considerable uncertainty: will UK banks have passporting rights into European markets? Will business migrate to the Eurozone (Frankfurt, Paris and Amsterdam in particular are competing for business), particularly Euro-clearing? Will Brexit increase the City's "offshore" activities (even as it reduces its core Euro based business)? And so on.

The speed at which sales can proceed also depends crucially on the political climate and the perceived backlash the government would face from selling at a massive loss. In this sense it is worth noting that the speed of reprivatisation is not simply a 'given' which Labour cannot control, but is something that could be affected by the party's own actions, depending on the importance attached to retaining control of RBS (and thus to vocally opposing the sale).

5.3 RBS's conduct and business model

The official narrative from RBS management and the government is that the bank has now dealt with its legacy issues and is ready to return to the private sector. Certainly, the bank is in a very different shape from the time of the bail-out. For the first few years after 2008, its strategy was to dig itself out of the crisis the same way it got into it: by continuing to operate a large globe-spanning investment banking operation and make large bets on global markets. By 2012 it became clear that this strategy was failing. A new strategy was devised to refocus the bank's activities on UK retail and commercial banking. The investment bank was shrunk drastically, with many of its operations being sold off, refocussing on serving corporate clients rather than on proprietary trading.

In recent years, the bank has combined this narrowing of focus with the restructuring required in order to prepare for ring-fencing. UK ring-fencing regulation came into force on the 1st January 2019 and requires the separation of essential banking services from investment banking activities. RBS intends to place most of its UK and Western Europe banking businesses inside the ring fence. RBS's investment bank

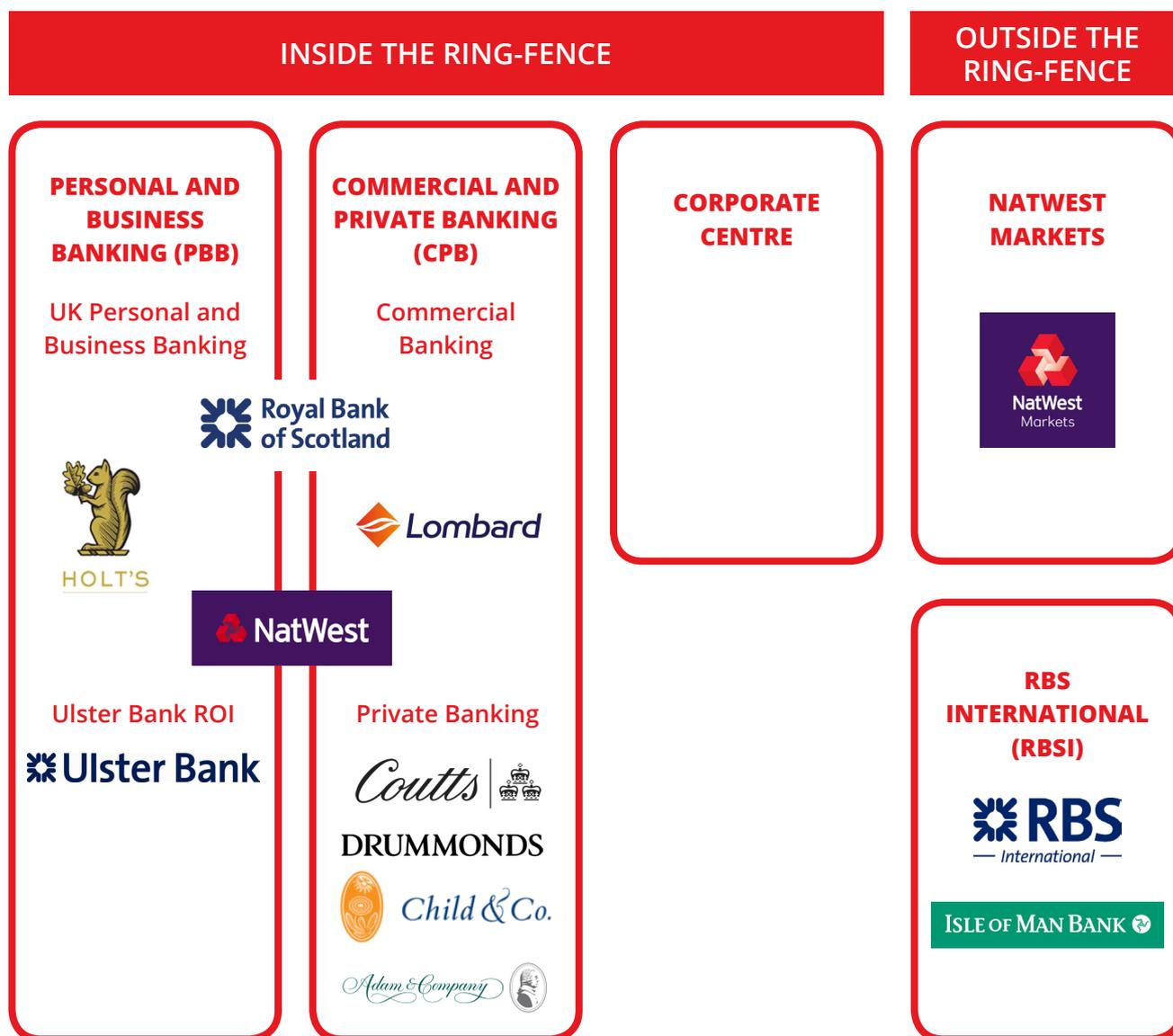
(NatWest Markets) and their offshore business (RBS International) will be separate entities *outside* the ringfence.¹⁸⁸ Figure 17 (overleaf) shows how the group's reporting segments and brands line up inside and outside the ring-fence.

The restructuring that has been carried out to meet ring-fencing requirements involves clear legal and business separation, especially of those entities outside the ring-fence. Any future Labour government's plans to further reduce the size of RBS or to split it up would do well to push on this open door. Preparations for ring-fencing are likely to have achieved much of the restructuring required for such a sale. That said, we note that NatWest Markets, in addition to on-going investment banking business now also contains legacy "run-off" assets after the closure of the non-core division "Capital resolution" in 2017.¹⁸⁹ These "run-off" assets may complicate any sale of the investment bank.

This narrowing of focus, under the leadership of Ross McEwan, appears to have been quite successful. The bank finally returned to profitability in 2017 and recorded a profit of £1.6 billion in 2018. Total Assets have fallen from a peak of £2.4 trillion in 2008 to a more modest £694 billion at the end of 2018. Similarly, Risk Weighted Assets have fallen from £609 billion in 2007 to £189 billion in 2018. Confirming that progress, in November 2018 the Financial Stability Board removed RBS from their list of Global Systemically Important Banks (G-SIB).¹⁹⁰

Another factor in deciding what to do with RBS is that some uncertainty remains about just how stable the new bank is. On the one hand the bank boasts its Core Equity Tier 1 capital ratio has risen from 2.9% in 2006 to 16% in 2018 today. On the other, as the Financial Times reports, the less malleable Leverage Ratio has actually fallen since 2006.¹⁹¹ The difference might reflect genuinely less risky assets, but it could also reflect overly optimistic risk-weighting. What's more, by comparing the Market Value of Ordinary shares (excluding B-shares) to Total Assets we see that, in particular since the Brexit referendum, the value market players are willing to put on RBS is falling. In short, while the bank itself judges its assets as less risky (i.e. via RWA), the market is trading the firm's equity at a deeper discount to the bank's accounting of its book value.

Figure 17 RBS organisational structure



A similar story is true of the bank's legal troubles. The bank has settled various legal issues which were seen as a roadblock to reprivatisation: most significantly, a US court case for mis-selling mortgage-backed securities before the crisis was concluded with RBS paying a \$4.9 billion (£3.6 billion) fine.¹⁹² The deadline has also passed for small businesses to claim compensation for mistreatment by the notorious Global Restructuring Group (GRG). At time of writing only 1,230 complaints had been made from an estimated 16,000 eligible businesses and £10m paid out from a £400 million fund.¹⁹³ Once again, however, uncertainty lingers: while this potentially lifts another uncertain liability from over the bank's head, victims can still bring court

cases against the bank, and at least one involving international as well as UK customers is known to be in the pipeline. Indeed, in December 2018 the FT reported that "The UK financial regulator's decision to drop an investigation into certain managers at RBS's disgraced restructuring unit is being legally challenged by the former head of a company sold off by the unit."¹⁹⁴

There are also questions over how far the bank's underlying culture has really changed, and thus the public policy implications of relinquishing public control – for instance, for community branch coverage and treatment of customers. Although Fred Goodwin and other senior directors were removed during the crisis, the next level

of management remains largely intact, with natural staff turnover only slowly replacing these managers many of whom could remain in place for years to come.

The scandal of GRG, which pushed healthy businesses towards bankruptcy and in some cases then stripped their assets, relates to conduct after the 2008 crisis while the bank was in public ownership. It starkly illustrates the lack of political will to reform the bank's culture and the willingness of the Treasury to turn a blind eye to misconduct. One person we spoke to suggested that the way this scandal was handled by the bank, including its aggressive attitude to litigation and the alleged falsification of documents, "is evocative of a very toxic culture within RBS."¹⁹⁵

RBS is also being sued by a Spanish investor who claims that its former head of derivatives trading (a convicted rate rigger while at Barclays) manipulated the Euribor rate while at RBS to benefit the bank's derivatives books. Lawyers for the complainant describe it as endemic to a "rotten bank". RBS is taking the line that he was a "rotten apple" and a "rogue individual" and reportedly destroyed his personnel file after the case started.¹⁹⁶

Meanwhile, RBS is pressing ahead with an aggressive programme of branch closures. This goes back some years but has accelerated since the collapse of the bank's attempts to float off Williams & Glyn as a new challenger bank with 300 branches (one of the original conditions of the bail-out imposed by the European Commission). They argue that this means they now have two parallel branch networks (Natwest and RBS) and that maintaining these is uneconomical.¹⁹⁷ In May 2018 the bank announced a fresh wave of 162 closures with the loss of 792 jobs.¹⁹⁸ In September it announced a further 54 closures with the loss of 258 jobs.¹⁹⁹ A quarter of these were the 'last bank in town'.²⁰⁰ Effectively, the price for RBS's failure to meet the only conditions imposed on its taxpayer bail-out is the loss of high street banking for communities across the country. It is betting instead on digital banking with plans to launch a new standalone digital consumer banking platform, Bo.²⁰¹

Although now only a fraction of what it was once, the RBS Group still has an extensive branch network. Exact figures are difficult to find, but we estimate that RBS and Natwest together have at least 793 branches remaining (RBS mainly in Scotland, Natwest mainly in England and Wales).²⁰²

This compares to around 2,000 branches in the Lloyds Group (including Halifax and Bank of Scotland).²⁰³ As such, it is clear both that RBS is failing to operate in the public interest absent a more interventionist approach from government, and that it retains significant branch assets which the government could seek to protect from further cuts.

5.4 Summary of current situation

In summary, RBS is a powerful player in the UK retail banking market and has the potential to be a significant force for good. The question therefore arises of how, assuming it does retain a majority stake in RBS, a Labour government could use this stake to turn the bank towards public policy objectives: serving small businesses and retail customers, promoting financial inclusion, contributing to regional rebalancing and improving the economy's resilience to economic shocks.

There are, of course, those who argue that this is not desirable: RBS's toxic brand, toxic culture, dwindling branch network and legacy issues mean that the best option is simply to offload it rather than try to turn it into something useful. In addition to the issues discussed above, like many big banks RBS's IT systems are old and complex and a source of problems – for example, millions of customers were locked out of online accounts in September 2018 after a software upgrade went wrong.²⁰⁴

However, it is important to consider the counterfactual. RBS will continue to exist whether or not it is in public ownership and is likely to remain one of the UK's biggest banks. It will take many years for any new public banking institutions to even approach its scale or market share. The question is therefore whether it should be allowed to return to the private sector and continue exemplifying bad practice in the banking system, or whether it should be retained as an important strategic lever for change to that system.

On balance, we believe that the benefits of retaining RBS in public ownership outweigh the costs should this remain open to a future Labour government. Not to explore these options would be to miss an opportunity to radically alter the UK's broken banking landscape, rather than simply returning it to its pre-crisis

shape largely unchanged. Below we consider a number of possible options and make some provisional recommendations.

5.5 Future Options

We now assess the choices facing a future Labour government given the likely conditions they will inherit. The criteria for the choice should obviously be the cost / proceeds and the estimated potential for using RBS as a lever for progressive social change, narrowly within the financial sector, and more broadly across society.

5.6 Option 1: Sell all shares

The first option is simply to sell all shares, pocket the proceeds and return the bank to private shareholders. This option could be largely justified on two grounds. First, that the proceeds would be better used elsewhere than by using control of RBS as a lever for progressive social change, regardless of any loss compared to the purchase price. Second, that progressive change to the financial system is better achieved through other tools, notably regulation and a combination of the Post Bank and the National Investment Bank.

On balance however, this seems like a wasted opportunity. Brexit and a weak recovery seem likely to keep the pressure on the share price, so selling would not raise as much money as it once would and would lock in a large loss. Despite the uncertainties that remain, the bank has come a long way to changing its activities. It also trades at a discount to book value and at the time of writing, according to the Financial Times, 21 out of 22 forecasters have the shares as a hold, outperform or buy.²⁰⁵ All of which adds weight to the idea that the government could benefit more from keeping a stake in RBS, first as a lever for progressive change, and second a source of revenue as the bank restarts paying dividends. The question then becomes: what ownership stake in the bank should the government aim to hold?

5.7 Option 2: Purchase 100% shares and transform RBS

Perhaps the most radical option that Labour could take would be to buy out all of the other remaining ordinary shares in RBS and create a fully public bank. With full ownership and control it could make more radical alterations that would enable progressive change throughout the financial sector and wider economy. Those radical alterations could involve the business model (e.g. size, activities, geographical spread etc) but also the ownership model. For example, 100% ownership could open the space to transform the bank into a mutual, owned, for example, by customers and employees with extremely limited transferability of shares. A second alternative would be to transform the shares and the bank into one owned in trust for the public benefit, as we have proposed for the Post Bank. This option was examined and proposed by the New Economics Foundation (NEF) in 2015.²⁰⁶ But the NEF proposal went further than the trust model. It also examined the possibility of turning RBS into a network of local banks.

In its 2017 manifesto, Labour committed to reviewing the options for RBS' future, including along the lines suggested by the NEF report. In the NEF report the bank would be split into autonomous local units, each with a mandate to provide access to basic banking services within their local area and to lend only within that area. For example they suggest 130 local banks in England, an average of one per 408,000 people. These units would remain part of the RBS group at national level, which would provide them with back-office support including IT services and some investment banking functions (as the Landesbanken and DekaBank do for the German Sparkassen). However, they would be managed independently by multi-stakeholder boards including representatives of workers, customers, local government and the local community.

This option has the potential to make the most use of RBS as a policy tool itself. Moreover, the combination of Post Bank on a new footing, a National Investment Bank and a radically transformed RBS (whether mutualised, publicly owned, held in trust or some other ownership arrangement) would be a massive and progressive change for the UK financial system. Full ownership involves maximum public control, maximum use of the bank's assets (i.e. its large market share and SME loan book), and maximum transformation

of the bank's structure and culture. Based on evidence from elsewhere, this could deliver higher levels of SME lending, better branch coverage, better customer service and more resilience to economic downturns.

Of course, achieving these benefits in practice would require a concerted and well-managed effort to reform the bank's culture and management as well as its structure. This effort would need to be made alongside that required to greatly expand the role of the Post Bank, launch the National Investment Bank, re-regulate the financial sector more broadly, as well as the wider policy measures a progressive Labour government would want to implement. By changing the bank's ownership model it would 'lock in' these benefits and make them resilient to future re-privatisations or changes of government. It also has the potential to deliver benefits to the public purse over time if it remains in public ownership. Nevertheless, the efforts required would have to be carefully considered in light of resources available and the many things Labour will need to work on upon coming to office.

Furthermore, given the Conservative governments continued share sales in 2018 this option is becoming more expensive, perhaps prohibitively so (even with a tumbling share price). Even without further sales, it would cost more than £9 billion at current prices (£2 per share) to buy the remaining shares in order for the government to own the bank outright, a necessary precondition for changing its ownership structure.²⁰⁷

In addition to the purchase price, restructuring costs must also be taken into account. Although it is difficult to estimate these costs, as a comparison, the failed attempt to spin out Williams & Glyn cost £1.8 billion, and a restructure on this scale could be even more complex and costly. Some have argued that RBS's IT systems and business processes are so highly centralised that devolving the bank's operations – or even identifying which customers should be allocated to which local branch or region – would be an extremely difficult and expensive operation. On the other hand, we also spoke to those who felt that these issues were often raised as a smokescreen, and that in practice the real issue (manifested in the failed Williams & Glyn spin-off) was lack of political will and strong strategic management.

Finally, questions would arise as to how a public RBS, whether mutualised, or with shares held

in trust, would fit in a broader ecosystem with an expanded role for the Post Bank. While not necessarily competing with each other, RBS could potentially slow the growth of the Post Bank, and at the very least the relation between the two would need to be analysed and defined.

On balance, given the increased cost after continued government share sales, the uncertainties around transformation and the proposed role for Post Bank, this option seems considerably less attractive than at the time of the NEF report. A more viable option might be to pursue other ways of improving RBS, keeping the bank as shareholder owned but with a majority government stake. This is what we examine next.

5.8 Option 3: Policy options open to the government as a majority shareholder

A policy of halting the government's planned privatisation and retaining a majority stake in RBS has the potential to combine some of the benefits of the two options outlined above. It is likely to involve minimal change in the shareholding while allowing the government to keep control of the company and influence its behaviour and structure, including the possibility of selling the private bank and offshore business and part of the investment banking business. What's more it keeps open the possibility of purchasing a 100% stake in the future with a view to more radical transformation as outlined above.

If, on coming to office, the government still has a majority stake, **we recommend that some shareholding above 51% could be sold to raise funds for use elsewhere in the government's budget or, for example, proceeds from sales of excess shares could be used to help capitalise the Post Bank.** At current prices and shareholding this would generate £3 billion, however it is important to note that the receipts from RBS share sales are already built into the government's fiscal forecasts, which are used as the basis of Labour's spending plans. As such, this would have to be weighed against other Labour government spending plans. Alternatively if the shareholding has dropped below 51% the cost of buying them back is likely to be relatively small.

Although majority shareholders have limited ability to influence day-to-day operational decisions, they can hire and fire senior

management and set the bank's overall strategy – whether formally, through votes at AGMs, or informally, by exercising influence behind the scenes. Indeed, successive governments have done this with RBS, in spite of the legal fiction that they exercise no influence over the bank and that the stake is managed entirely at arms-length through UK Government Investments (formerly UK Financial Investments). For example, former Chief Executive Stephen Hester is widely known to have been forced out by George Osborne, while insiders suggest that the Treasury was also behind the change in the bank's strategy implemented around this time. The Parliamentary Commission on Banking Standards concluded that “the Government has interfered in the running of the two partly State-owned banks, particularly RBS. On occasions it has done so directly, on others it appears to have acted indirectly, using UKFI as its proxy”, describing UKFI as “a fig leaf to disguise the reality of direct Government control.”²⁰⁸

There are several actions a more openly interventionist approach might include. Prime among them would be selling off “socially useless”²⁰⁹ parts of the business. As mentioned above, the preparations for the UK ring-fencing regulations coming into effect in 2019 could be of considerable use here. The investment banking business is already separated into NatWest Markets, and the offshore business into RBS International. As such there is legal and operational space between them and the ring-fenced parts of RBS. Furthermore, it would seem from the little it is possible to glean from the public disclosures that Private Banking, with brands such as Coutts, could also be separated from the core businesses of personal, business and commercial banking. A rough estimate from the latest accounts, and comparison with other stand-alone private banks, suggests its equity might be worth between £1-2 billion. Similar reasoning suggests that RBS International might raise similar amounts. Estimates for NatWest Markets are harder to make, not least because, as noted above, it now contains the remainder of RBS's non-core / run off assets after the closure of the dedicated non-core division in 2017.

Overall, Labour may feel that businesses aimed at financial market trading, tax avoidance and banking for so-called High Net Worth Individuals (and Ultra High Net Worth Individuals) would fall outside the remit of a public bank. It should be stressed however that in order to judge the feasibility, let alone the value, of such sales requires access to detailed financial information

which is not in the public domain, and is therefore outside the scope of this report. An incoming Labour government would need to dedicate considerable resources to carry out this analysis and due diligence before such a sale could be considered.

A more hands on approach to majority ownership might also include (but not be limited to): a clear-out of senior management; a moratorium on further branch closures; wider reform of the bank's strategy and structure and exerting pressure to reform the bank's culture to stamp out abuses of the kind seen at GRG. Importantly, it might also include seeking to transform the company's governance structures to include a wider range of stakeholders on the Board, drawing on the recommendations of the recent review commissioned by the Shadow Business Secretary and Shadow Chancellor of the Exchequer and conducted independently by Professor Prem Sikka, Professor Alastair Hudson and others.²¹⁰

As part of this, the government could also explore devolving or decentralising the bank's governance in a way that would partially achieve the aims of the NEF proposal. This could resemble the Handelsbanken model discussed above: i.e. giving more autonomy over lending decisions to local branches, and creating regional offices with more autonomy to oversee these decisions. An alternative geographical split would be to devolve more power to RBS in Scotland and NatWest in England and Wales, and public disclosure by RBS suggest legal entities are already somewhat structured in this way. Such a split would not only aim to partly breakup the bank into smaller parts but also to encourage relationship banking by allowing local experts to make decisions. Such restructuring is open to the same objections to the NEF proposal discussed above, i.e. that it would be costly and difficult. Some we spoke to also stressed that it would require a major investment in training and personnel to ‘re-skill’ RBS' workforce to engage in relationship lending. However, this investment might be justified if it substantively improved RBS' ability to act as a source of sustainable SME finance, regional rebalancing and resilience to economic shocks.

One question that some experts have raised with us is whether RBS' financial health is sufficient to bear this kind of investment, or – perhaps more seriously – whether its profitability depends on exploitation of customers and ruthless cost-cutting, and would not survive a shift to a different

business model. Clearly, other banks – both in the UK and overseas – are able to make a profit without adopting the worst aspects of RBS’s business practices. However, it remains the case that RBS has only recently overcome a string of legacy issues and therefore that its profitability remains more fragile than that of many other banks. This would need to be considered as part of any strategy for reforming the bank’s business model. As with the Post Bank, the government would need to decide the balance of priorities between retaining RBS as a source of long-term revenues for the public purse, and retaining it as a lever of public policy. Of course, in the case of RBS there is perhaps less potential to sustain a loss-making bank through public subsidy given that the bank would remain a shareholder-owned plc.

There are other limits to what the government can achieve with RBS as long as it remains in shareholder ownership and thus governed by UK company law. One concerns the durability of any changes it might make to future governance, since it cannot radically reform the bank’s ownership or governance model. Another concerns the more limited direction the government can exercise as a shareholder, as opposed to a full public ownership model in a new institution which would give it and other stakeholders a more direct ability to shape the structure and management.

Finally, there may be the risk of legal challenge from minority shareholders. There are two ways for such a challenge to be brought: ‘unfair prejudice’, where minority shareholders can allege that the actions of the majority are unfairly impacting their interests (e.g. their reasonable expectation of profits and dividends);²¹¹ or derivative actions, where shareholders can allege that the directors have breached their duties to the company (either by failing to exercise due care and skill, or by failing to act in the company’s best interests).²¹² The courts can require a wide range of remedies, including injunctions to prevent a planned course of action that would damage the company or its shareholders, as well as compensation for minority shareholders or a mandated buy-out of their shares.

In theory, such a challenge could be brought if RBS’ management was deemed to be acting against the company’s interests by failing to maximise profits, for instance by lending at below market rates, reopening branches deemed uneconomic, etc. However, in fact there is no legal duty on company directors to maximise profits (indeed, directors are supposed to “have

regard” to their impacts on the community and the environment and their relationships with customers, among other things) and in any case directors have wide discretion to judge what will best serve a company’s interests – so it seems highly unlikely that such a challenge would succeed. A one-off decision that imposed significant costs on the company and that could be considered not to be in its long-term business interests (such as a costly restructure to localise the bank) could perhaps be more likely to raise a challenge, although it is still doubtful whether such a challenge would succeed.

In practice, the hurdles for both these types of action are high. Courts tend to err on the side of upholding directors’ discretion and decisions made by companies through the normal process of majority shareholder approval. Unfair prejudice is most commonly used to resolve disputes between partners in small private businesses, and is rarely applied successfully to large public companies. The law was changed in 2006 to make it easier to bring derivative actions,²¹³ but the courts remain conservative in applying it.²¹⁴ Provided that the government could make a business case that their actions were justified, particularly in light of legislation designed to promote enlightened and socially responsible company behaviour, a successful challenge seems unlikely. However, clearly proper legal advice would need to be taken on a case-by-case basis.

On balance, **we recommend that an incoming Labour government halt the government’s planned privatisation and retain a controlling majority stake. It should then use this stake to proactively turn RBS’ business model more towards public interest objectives.** However, devising a more detailed strategy for this will require a deeper understanding of the financial position of the business and the practical constraints on any structural reorganisation than it has been possible to gain for this report.

5.9 Additional considerations

The Turner Report, ‘Financing Investment’, recommends that RBS should become the vehicle through which the National Investment Bank supports SME lending, being given a new legal mandate to direct investment towards small businesses. It also recommends that it should become a hub for advisory services and skills development for SMEs, and that it should

co-establish a new venture capital arm providing early-stage equity financing.

The report notes that further work is needed to establish how RBS could be given such a legal mandate, although it also says that legal changes are not technically required in order to change the bank's strategy in practice: as long as the government maintains a controlling stake, it has the ability to change the bank's strategy and to install directors.

Of course, if RBS was to become an essential pillar of the new public banking system, legal changes would likely be needed to make this role more durable. However, there are questions over whether it makes sense for RBS to occupy a legally privileged place in the public banking ecosystem in the absence of the state being able to buy the bank outright and change its ownership model to safeguard it from future reprivatisation or changes of government. If the bank was reprivatized under a future Conservative government, it would return to being just another large shareholder-owned universal bank, no different from HSBC or Barclays, and there is no obvious reason why it would retain a special role.

Even without a reprivatisation scenario, there are considerable issues of governance, culture and operational capacity that would need to be addressed in order for RBS to play the role envisioned in the Turner report. Although it has a large SME loan book and expertise in SME lending, this is far removed from the local relationship lending undertaken by institutions that play a similar role in other countries. Indeed, the bank remains one of the worst offenders when it comes to exploiting SME customers, while its aggressive programme of branch closures also undermines its capacity to provide services to SMEs across the country (an essential aim of the Turner proposals) and to engage in relationship-based lending. Finally, it is widely regarded as having failed to stamp out the culture of profiteering, excessive risk-taking and customer exploitation which prevailed before the financial crisis, with many senior leaders from that era still in place.²¹⁵

The idea of RBS becoming the government's flagship source of support for SMEs may be greeted with scepticism in the small business community if not accompanied by significant reforms. One option is that RBS' role in SME lending be seen as transitional – filling a gap until such time as new public or stakeholder banks can be incubated to provide a more diverse and

durable set of channels for SME lending. On balance, we consider that the Post Bank is better placed to become the primary conduit for NIB support for small business lending, and that the Regional Development Banks are best placed to offer loans and advisory services to larger SMEs, and to become hubs for venture capital and early-stage equity financing.

A final option would be to use RBS in one way or another to support the establishment of a Post Bank. For example, this could include the transfer of some of its SME loan book to the new bank (either by selling it or by incentivising customers to switch voluntarily), or requiring it to provide technical assistance, capital investment, or even premises in areas where it is closing branches. The options for doing this through the exercise of the government's rights as a majority shareholder may well be limited. Compared to an overhaul of RBS' own business model, using its assets to support what is effectively a competitor would be much more open to challenge from minority shareholders as a breach of the duty to promote the company's interests.

The exception to this might be the sale of part of the SME loan book if a reasonable business case for this could be made. This could encounter some of the same pitfalls faced by the failed Williams & Glyn spin-off – in particular, the risk that an unreformed and unsympathetic management would not be fully committed to making a success of the sale – but logistically it would be more straightforward. As noted above, the government could also raise revenues to help capitalise the Post Bank by selling its excess shares in RBS, should any remain. It should be noted however that SME banking is often tightly bound to personal banking of business owners, not least as owners often mortgage their homes to obtain credit for their small businesses which might otherwise struggle to obtain credit and post acceptable collateral. For a public bank seeking to increase relationship banking, splitting SME banking from the personal banking of the business owners might pose significant challenges.

However, the history of the RBS bail-out provides ample justification for the government and/or regulators to require such measures even without the continued existence of a majority stake. The Williams & Glyn spin-out was originally imposed by the European Commission as a condition for the taxpayer bail-out, and was intended to improve competition in the banking sector and

reduce RBS' unfair advantages. After the spin-out failed, a compromise was agreed whereby RBS would "fund and deliver a £775 million package of measures designed to improve competition in the UK business banking market".²¹⁶ This package already includes a 'capability and innovation fund' to support its competitors to provide banking services to SMEs, and an 'incentivised switching scheme' – essentially a fund for challenger banks to provide incentives for existing RBS customers to switch.²¹⁷ In February 2019 the Banking Competition Remedies body awarded the first tranche of this money to Metro Bank, Starling Bank and Clear Bank – with Metro securing the largest pot of £120 million.²¹⁸

This establishes the principle that it is legitimate for policymakers to ask RBS to provide support to its competitors, particularly new challenger banks, in exchange for its taxpayer bail-out. Under a new Labour government, it would be logical to extend these requirements to require that particular additional support be given to new public and co-operative banks, including the Post Bank.

Of course, this approach leverages only a tiny proportion of RBS' vast resources for public interest objectives, as opposed to its entire balance sheet. **We therefore recommend that this approach be used in conjunction with, and not as an alternative to, efforts to reform the business model of RBS itself.**

6 NATIONAL INVESTMENT BANK: ANALYSIS AND RECOMMENDATIONS

Labour's 2017 manifesto proposed to "establish a National Investment Bank that will bring in private capital finance to deliver £250 billion of lending power... and support a network of Regional Development Banks that will be dedicated to supporting inclusive growth in their communities."²¹⁹ Also in 2017, Labour published 'A National Investment Bank for Britain: Putting dynamism into our industrial strategy', which elaborated on the proposed design of the bank.²²⁰

In the following sections, we outline a series of recommendations relating to the design of the National Investment Bank, building on this work.

6.1 Mandate

As outlined in section 3.2, a key reason why NIBs can be powerful agents of economic transformation is that they traditionally execute their roles in coordination with governmental policies. Most do this by focusing lending on areas that have been prioritised through industrial policy, targeting investments against the grain of market signals in order to drive structural transformation. While some NIBs are given a narrow mandate which explicitly refers to the sectors, type of customers or activities that a NIB is expected to support, many of the more successful NIBs have broader mandates that enable them to support a wider range of economic objectives and respond to emerging priorities.²²¹

Importantly, as a bank with its own balance sheet, it is important that the NIB's primary activities relate to the deployment of repayable financial instruments (such as debt and equity). This means that the projects it invests in must be 'bankable' – i.e. they must be expected to generate future revenue streams that can be used to repay the finance. Importantly, the NIB should not be viewed as a replacement or substitute for government spending.

We therefore **recommend that the NIB should be given a broad mandate to support the government's industrial strategy**, through the use of repayable financial instruments. This approach enables the creation of a powerful synergy between finance, regulation and other policies, which can be simultaneously coordinated to drive structural transformation. This close alignment between the German KfW and government policy has been instrumental to the systemic greening of Germany's economy through the Energiewende policy.²²²

6.2 Ownership and institutional arrangements

We recommend that the NIB is established as a public financial corporation that is wholly owned by the Department of Business, Energy and Industrial Strategy (BEIS). The NIB should consist of a head office located outside London, and 12 'Regional Development Banks' located in each of the nine regions of England, plus Scotland, Wales, and Northern Ireland. These will have regional boards and with autonomy in regards to the direction of lending, but will not be legally distinct entities. As will be discussed further below, for some categories of lending (e.g. to small businesses) we recommend that the NIB branches on-lend via intermediaries, whereas for other types of lending (e.g. larger firms and infrastructure) we recommend that the NIB branches lend directly to customers.

In order to support its broad mandate, the NIB will need to be able to invest in a wide range of areas, and develop significant in-house expertise. As noted in section 3.2 a key difference between successful NIBs and private financial institutions is the breadth of expertise and capacities contained within staff. In many cases this includes not only financial expertise but significant in-house engineering and scientific knowledge about the sectors the bank is active in and the nature of the

investments being made. This enables investment decisions to be based on a wider set of criteria than relying on market signals alone, and means they are better placed to appraise social and environmental considerations.²²³

We recommend that the NIB and regional branches are most effectively structured around the following operational 'arms':

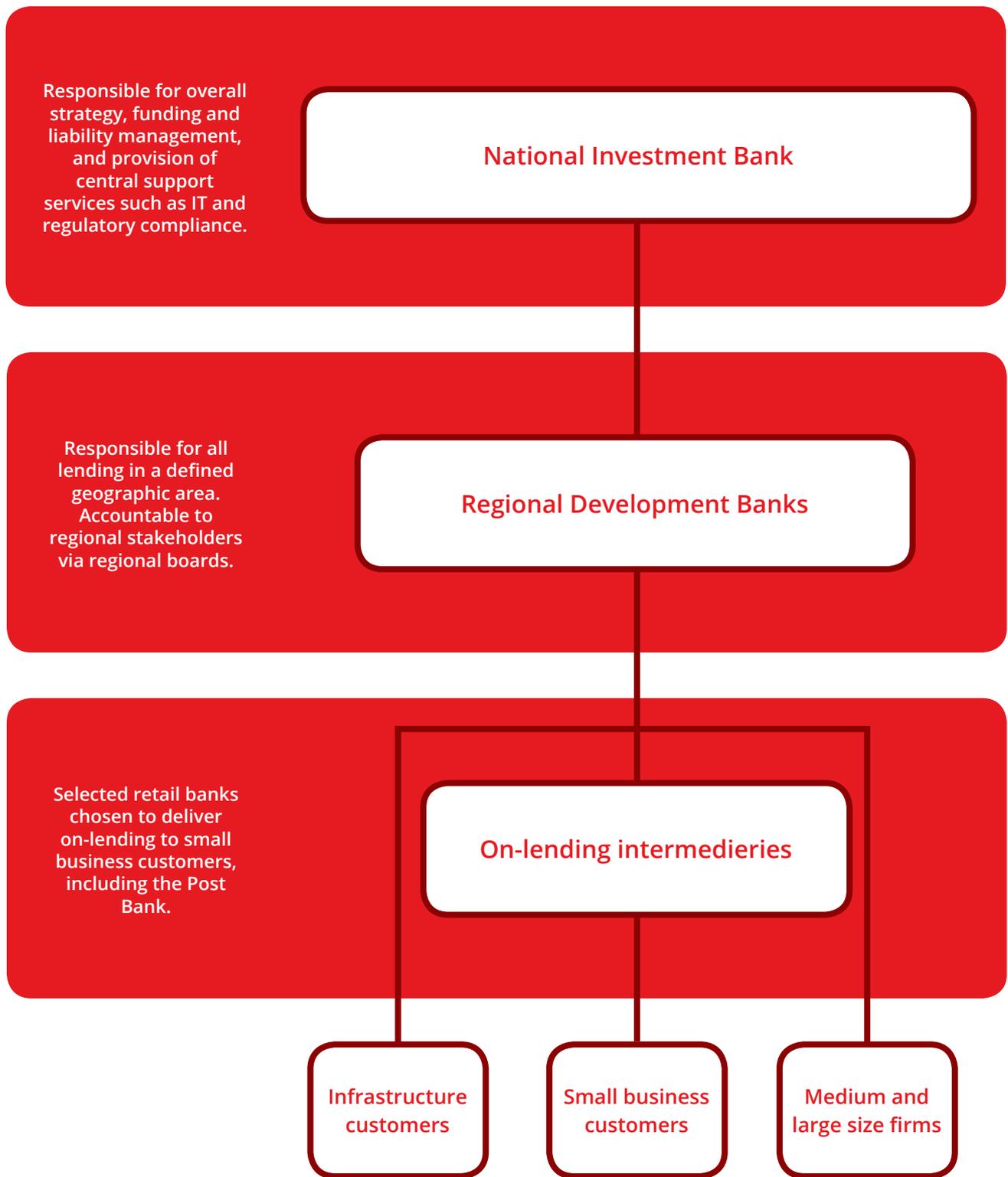
- **Enterprise arm:** The enterprise arm will provide low-cost financing to firms that are willing to invest in areas that support the priorities of the bank. Importantly, it will not provide general support to all firms, or bail out failing firms – instead it will focus on stimulating investments that would otherwise have not been made, and on nurturing new and existing industrial landscapes that align with the bank's mandate. Customers of the enterprise arm will include SMEs, large firms, social enterprises, cooperatives, and public corporations.
- **Infrastructure arm:** This infrastructure arm will provide low-cost finance for infrastructure investments in areas such as energy, water, housing and transport, which align with the wider missions of the bank. Labour has committed to creating a National Transformation Fund (NTF) that will spend £250 billion over ten years in upgrading infrastructure across the country. The NTF will be the primary vehicle for delivering the infrastructure commitments set out in Labour's manifesto. It will also be the primary vehicle for funding infrastructure projects that are deemed to be of high strategic importance, such as critical energy infrastructure. As the NTF is a vehicle for government spending, it will be able to fund infrastructure projects that generate social benefits which cannot be captured in the form of future revenue streams. In contrast, the NIB will only be able to finance infrastructure projects that are 'bankable' – i.e. that are expected to generate future revenue streams that can be used to repay the finance. However, the decision of the European Investment Bank, which financed £7 billion of infrastructure projects in the UK in 2016, to freeze its UK operations creates a potentially significant gap in the availability of low-cost, long-term financing for infrastructure projects which the NIB should seek to fill. Customers of the infrastructure arm may include large firms, local authorities, nationalised utilities, and housing associations.
- **Innovation arm:** The innovation arm will work closely with other actors in the innovation

ecosystem – such as UK Research & Innovation, universities, the Catapult Network, NESTA and innovative firms – to identify opportunities for making strategic public investments across the innovation chain. In the UK, policymakers have traditionally ascribed little role to the public sector in driving innovation beyond funding universities and basic research. However, many major technological breakthroughs – from the internet and microchips to biotechnology and nanotechnology – were only made possible by high-risk public investment, including the early-stage funding of innovative companies.²²⁴ In each of these areas the private sector only entered much later when returns become more certain, piggybacking on the technological advances made possible by public funds. At present the UK critically lacks this type of finance, and instead innovators are forced to work with exit-driven private venture capital firms whose short-termism often acts to stifle innovation rather than foster it. The innovation arm of the NIB would therefore play a public venture capital role, providing high-risk, patient capital for innovators and high-tech start-ups.

Since 2014 British Business Bank (BBB) has played an important role supporting access to finance for smaller business. The BBB houses significant expertise on the SME sector, and works with growth oriented companies to help them articulate their funding requirements, develop their investment propositions and increase their chances of securing the most appropriate package of finance for their needs. The BBB is also responsible for central government's investments in venture capital.

While the BBB has successfully helped firms to grow and expand, there are a number of constraints which have limited its ability to drive transformational change. Firstly, the BBB's mandate, which is mainly focused on fixing market failures in the supply of finance for smaller business, is narrower in scope than most state investment banks elsewhere in the world, which tend to have a broader mandate. Second, the BBB's resources (around £200 million a year) are very small relative to the size of the UK economy and compared with other successful state investment banks. Despite the name, the BBB is not actually a bank, but more akin to a fund. It is not able to leverage its own balance sheet, meaning that its operations are limited by the fixed amount of resources it receives from the government.

Figure 18 **Structure of National Investment Bank**



We **recommend that the BBB is used as the basis for creating the NIB**, and that its current investments, staff and other assets are subsumed into the new legal entity.

6.3 Investment activities

At present Labour advocates a “mission-oriented approach to industrial strategy, whereby the public sector makes strategic investments to catalyse the private sector to innovate across different sectors to meet the key public policy challenges of our age — from climate change to changing care needs in the context of an ageing population.”²²⁵

The case for building a modern industrial strategy around missions is compelling and increasingly recognised.²²⁶ Whereas orthodox economic policy focuses on ‘de-risking’ and ‘levelling’ the playing field, mission-oriented policy seeks to tilt the playing field in the direction of desired goals. It involves strategic thinking about the desired direction of travel, the kind of technologies and industrial landscapes needed to get there, and the policy frameworks required to make it happen.

Labour have identified two initial missions – one focussed on outputs related to the green economy, and one focussed on the inputs necessary to make the UK an innovation nation.²²⁷

1. 60% of the UK’s energy will come from low carbon or renewable sources by 2030 to help us meet the challenge of tackling climate change.
2. To create an innovation nation with the greatest proportion of high-skilled jobs in the OECD and 3% of our GDP on Research and Development by 2030 as part of a commitment to moving to a high skilled and more productive economy.

Labour’s 2017 manifesto also stated that: “The National Investment Bank and regional development banks will be charged with helping support our co-operative sector. Labour will aim to double the size of the co-operative sector in the UK, putting it on a par with those in leading economies like Germany or the US.”

We therefore recommend that the NIB’s investment activities initially focus on three core areas:

- **Decarbonisation and greening the economy:** The case for adopting an economy wide green direction is urgent and compelling.

This does not just mean just a greater focus on renewable energy than fossil fuels, but also transforming patterns of production, distribution and consumption across the entire economy. As well as helping to address climate change, a green direction provides a significant opportunity for an investment-led rebalancing of the UK economy and a renewal of the UK’s industrial base. Investment in the green economy should be supported both on the supply side and demand side. Today NIBs are the largest global funders of the deployment and diffusion phase of renewable energy, outpacing investment from the private sector. On-going public investment is essential to nurture new green technologies and industrial landscapes, however with the recent privatisation of the Green Investment Bank it is not clear where this is going to come from in future in the UK.

- **Regional rebalancing:** After years of neglect, many parts of the UK are in desperate need of economic renewal. Many industries have disappeared, and regions that were once mining or manufacturing hubs have suffered a long period of industrial decline and underinvestment in infrastructure. The new NIB should work closely with government to support a programme of local regeneration in areas which have historically been underserved in the UK. This might include financing new infrastructure, housing, and nurturing new industries.
- **Industrial transformation and economic democracy:** As noted above, Labour has committed to significantly expanding the co-operative sector. A key priority for the NIB should therefore be to support the creation of new cooperative start-ups, help existing cooperatives to grow and expand, and support traditional enterprises convert to cooperative ownership (through worker buyouts, for example). This could also include support for new cooperative banks.

6.4 Products and services

We recommend that the NIB should be placed at the centre of the investment process, nurturing knowledge and expertise, coordinating other stakeholders in the investment ecosystem and acting as a catalytic investor. In many cases, it will be appropriate for the NIB to invest alone, while in some cases it may be more appropriate for the

NIB to coordinate investment with other parties. Either way, the effect should be to act as a catalyst for change across different sectors.

In order to fulfil a broad mandate, the NIB will need to have a wide range of instruments at its disposal, including debt, equity and mezzanine products, suited to different areas of the risk landscape. The NIB’s enterprise arm must have the capability to provide capital across all stages of the business lifecycle, while the infrastructure arm must be able to structure finance for larger transformative projects. The NIB’s innovation arm must be able to provide equity-type funding and guarantees which are tailored to the meet the needs of early-stage innovative projects.

In line with its mission-oriented mandate, **we recommend that the NIB should create products that target particular issues, rather than generic offerings.** These products should offer finance to customers which meet criteria that are aligned with the bank’s missions, on favourable terms. Structured effectively, these products should be designed to transmit policy objectives more efficiently. Examples of programmes that could be offered by are outlined in table 6. Note that these are just hypothetical examples – it will be up to the management of the NIB to design the specific product offering.

Table 6 Examples of products offered by the NIB

Arm	Product
Enterprise	<p>Strategic scale-up loans: Labour’s industrial strategy has identified a number of sectors in which the UK has high or medium-high actual or potential competitive advantage, including carbon capture and storage, transport telematics, energy storage and low carbon chemical processing.²²⁸ The NIB could help to nurture and grow these industries through targeted low-cost loans to support investment in growth and expansion.</p> <p>Digitisation loans: It is widely recognised that improving the rate of diffusion of digital technologies from the minority of frontier firms to the majority of slow-adopting, low productivity firms in the rest of the economy is key to enhancing the UK’s productivity. This could be promoted by the NIB through targeted long-term loans at favourable interest rates for SMEs willing to invest in this area, accompanied by an outreach and marketing programme to stimulate demand.</p>
Infrastructure	<p>Transport decarbonisation: Labour has identified that in order to make the transition to a low carbon economy, a key priority will be decarbonising the transport network, including a move to electric vehicles.²²⁹ But there are currently significant challenges in the limited supply of vehicle charging points, and capacity issues with the current grid. The NIB infrastructure arm could therefore offer tailored financing to support the rollout of nationwide vehicle charging infrastructure, and increasing the capacity of the current grid system.</p> <p>Energy-efficient housing: Investments in energy efficiency is an effective way to reduce carbon emissions and lower household bills. As such, the NIB could play a role in transforming the energy efficiency and heating of buildings among households, businesses and community groups. It could do this by providing long-term loans at favourable interest rates to help construct new energy-efficient homes or commercial premises, and to improve the energy efficiency of existing properties.</p>
Innovation	<p>Research and development: Investment in research and development (R&D) has fallen over the past 30 years in the UK, and remains lower than virtually every other major advanced economy. Labour’s industrial strategy has set an ambition for spending of 3% GDP on R&D by 2030 as part of a commitment to moving to a high skilled and more productive economy. As such the NIB could provide a range of tailored loans and equity-type funding designed to promote investment in R&D. An example of this is the European Investment Bank’s ‘InnovFin Emerging Innovators’ and ‘InnovFin Corporate Research Equity’ products which provide risk finance for fast-growing or R&D-driven enterprises.</p> <p>Venture capital: The NIB could create and manage a portfolio of public venture capital funds that would invest into innovative high-tech SMEs in their early and growth phases, targeting strategic sectors that have been identified by the government’s industrial strategy.</p>

As a bank with its own balance sheet, it will be important for the NIB to find the right balance between risk and reward. Acting as lead investor in the economy necessarily means absorbing a high degree of uncertainty and accepting failures when they happen. In some cases, returns arise slowly and are negative in the beginning, while in other cases returns may never materialise. In structuring its investment portfolio the NIB should learn from the strategies of venture capitalist firms, structuring investments across a risk-return spectrum so that lower risk investments help to cover higher risk ones. This also highlights the importance of being able to capture some of the reward (the 'upside') that is made possible by the risk-taking and investment of NIBs.²³⁰ Where successes have occurred as a result of targeted NIB interventions that have benefitted specific firms, the NIB should be able to reap some of the financial rewards over time.²³¹ This can be done by retaining equity in the companies supported, just as private venture capital firms do, or sharing ownership of intellectual property.

The NIB should also seek to attach conditions to its investments in order to promote desirable structural change in the economy. This would involve making support conditional on meeting desirable criteria, such as committing to reduce their carbon footprint or implementing maximum pay ratios. Conditions could also be attached regarding the price, design or property rights over products that emanate from NIB support.²³² Structured effectively, the use of conditionality can be a powerful tool for promoting economic transformation.

In addition to lending operations, the NIB should also provide technical advisory services such as strategic planning, capacity building, and training programs help to create viable projects and work with businesses to prepare bankable investment plans.

6.5 Relationship with the wider financial sector

In Labour's document 'A National Investment Bank for Britain: Putting dynamism into our industrial strategy', the authors propose that the NIB adopts the on-lending model.²³³ However, as discussed in section 3.2, while the on-lending model allows fast implementation at scale by utilising existing branch networks, it is also subject to a number of limitations.

On balance, we consider that the on-lending model is most appropriate for lending to small businesses (firms with less than 50 employees), as these firms tend to rely on their local bank branch more than larger firms. We therefore recommend that the enterprise arm of the NIB should on-lend via bank intermediaries to ensure that small firms are able to access NIB support.

However, rather than simply disbursing credit through existing commercial banks, we recommend that NIB on-lending should be used as a tool for promoting wider structural change in the financial sector by favouring banks with the characteristics that we are seeking to promote. This can be done by extending eligibility criteria for intermediaries to include relevant characteristics such as:

- Branch density;
- Regional limits on lending activity;
- Use of a relationship banking model and reliance on collateral;
- Accountability to local stakeholders/customers/staff; and
- Implementation of social, environmental and de-carbonisation standards.

Such conditions would naturally favour the Post Bank over the large commercial banks, but may also enable other intermediaries, such as responsible finance providers, to benefit from NIB on-lending.

For lending to medium and large firms (firms with over 50 employees), infrastructure projects and venture capital and equity investments, we recommend that the NIB should seek to develop the capacity to lend directly via the Regional Development Bank branches. This means that developing significant in-house capacity and expertise in each of the regional branches will be key to the NIB's success. Staff will need to be able to identify, assess and appraise projects for their robustness and their alignment with the bank's missions.

6.6 Governance

Achieving the right balance between political representation and independent decision making is a key challenge for the NIB. While political representation can help to maintain alignment with government policy and maintain a path

of democratic accountability, steps should be taken to prevent undue political interference or capture by interest groups. It is important that management teams are free to make sound, long-term decisions in line with the NIB's mandate, free of day-to-day political interference.

Given the NIB's strong focus on regional rebalancing, it is also important that the Regional Development Banks and regional stakeholders have a meaningful role in the governance structure. Our recommended governance structure for the NIB is outlined in Table 7.

Table 7 Proposed governance structure of the National Investment Bank

	Membership	Role
Board of governors	HM Government ministers (HM Treasury and BEIS), an elected member from each of the Regional Development Bank boards, independent non-execs with relevant expertise, elected staff representatives with trade union backing.	Setting the overall policy framework of the NIB, within the mandate set by government policy; allocating the resources available to each of the regional branches (in consultation with the Operating Board), and for appointing and overseeing the Operating Board and the efficiency of the Operating Board. Also responsible for the appointment of the Chief Executive Officer (CEO) of the NIB.
Operating board	Executive members, including the CEO of the NIB, with qualifications covering banking practice, applied economics and financial accountancy. At least 50% would be drawn from the directors of the Regional Development Banks.	Setting the overall national framework of the bank's operations at national and regional level. The CEO will report on a quarterly basis to the Operating Board on the operational management of the bank, including the Regional Development Banks.
Regional Development Bank board	<p>One-third to be nominated by elected local representatives (e.g. local authority councillors).</p> <p>One-third to be elected by the Regional Bank's employees.</p> <p>One-third comprising representatives from other key local stakeholders, such as local chambers of commerce, social enterprises, charities and educational institutions.</p>	Ensuring that the management of each Regional Development Bank is delivering against the mandate and the strategy set out by the Board of Governors. Strictly a supervisory role and explicitly prohibited from interfering with day-to-day management and banking decisions.
Regional Development Bank directors	Senior management of each Regional Development Bank, composed of financial services professionals.	Overseeing day-to-day management of each Regional Development Bank's operations. The Directors of the Regional Development Banks will be appointed by the CEO, subject to the approval of both the Board of Governors and the Operating Board,. The regional directors will report nationally to the CEO, and regionally to the Regional Development Bank board, and where necessary to the Operating Board.

6.7 Financing

Labour has set an ambition for the NIB to expand its balance sheet to approximately £250 billion over a ten year period. As with all banks the NIB would need to start out with an amount of its own funds, or 'capital'. Having a strong capital base is important to ensure that any losses can be absorbed and that the bank is protected from insolvency. This initial injection of capital would need to come from HM Treasury.

In Labour's document 'A National Investment Bank for Britain: Putting dynamism into our industrial strategy', the authors propose that the NIB issue an equity tranche of £20 billion, which would be purchased by the UK Government.²³⁴ However, drawing on lessons from the capitalisation models of the European Investment Bank and the Nordic Investment Bank, it will be possible to adequately capitalise the NIB without such a large cash draw on the government. In both of these models, the member governments 'subscribe' (guarantee) an amount to the bank, which underwrites the bank's activities, but the amount of capital paid-in to the bank is significantly smaller. For example, only 6.82% of the Nordic Investment Bank's €6,141.9 million subscribed capital stock is physically paid in – the remainder of the subscribed capital consists of callable capital, which is subject to call if the Board of Directors deems it necessary.²³⁵ Following this model, the NIB could be adequately capitalised with £10 billion of paid in capital, with the remaining £10 billion consisting of callable capital. This would ensure that the NIB starts with a capital base big enough to support a major investment programme without causing an unduly large cash draw on the government budget.

Aside from initial capitalisation there would also be other initial start-up costs associated with establishing a sizeable new public entity. While these costs will ultimately depend on the specific organisational arrangements, a rough estimate can be arrived at by looking at the set-up costs of similar institutions. For example, as part of a feasibility study of the UK Green Investment Bank (GIB) the consultancy firms Vivid Economics and McKinsey & Co estimated initial start-up costs in the range of £11 million.²³⁶ Given that the NIB will be significantly larger in scale than the GIB, we consider that this to be an indicative lower bound approximation.

Once capitalised the NIB will use its capital base to raise additional funds to grow its balance

sheet to £250 billion over a ten year period. As discussed in section 3.2, there are many different ways that NIBs can fund themselves. In the UK context, raising finance from capital markets should not be a problem given the UK's strong credit rating. We recommend that the NIB should conduct ten annual bond issues over the ten year policy horizon, which would expand the NIB balance sheet to approximately £250 billion by the tenth year. However, it should be stressed that the volume of bond issuance in any given year should be determined by genuine financing need rather than arbitrary targets. NIB bonds would provide long-term and relatively low-risk investment opportunities for investors such as local government pension schemes and private pension funds. The NIB should also consider issuing green bonds for environmental and climate-focussed infrastructure projects to meet the growing demand from environmentally conscious investors.

Although the NIB should not be a profit maximising institution, we recommend that it should seek to achieve return on capital at least equivalent to the Government's medium term cost of capital, as is presently the case with the British Business Bank.²³⁷

6.8 Monitoring and evaluation

Whereas private banks tend to be evaluated on the basis of their performance, NIBs are often evaluated on the extent to which they are fixing perceived market failures. On this basis, ambitious NIBs are often criticised on the basis of 'picking winners' or 'crowding out'. While there are instances where criticism is merited, part of the reason often lies in the absence of monitoring and evaluation frameworks which adequately capture the dynamic outcomes of NIB investments and the additionality they generate.²³⁸ As a result, new monitoring and evaluation frameworks may be required in order to assess the performance of the NIB and RDBs that go beyond the narrow market failure framework, which could include an array of new indicators aimed at assessing the extent to which they have been successful at creating dynamic spillovers and advancing the government's industrial strategy.²³⁹

At the level of individual lending decisions, the NIB should take rigorous steps to assess the impact in scenarios with and without the bank's intervention, and evaluate success against the non-intervention scenario at project completion.

This is important to ensure that the NIB is focused on delivering additionality (i.e. making things happen that otherwise would not).

6.9 National accounting

When the government establishes a new body, privatises or nationalises an existing one, or enters into a new partnership or joint venture with the private sector, the resultant body must be classified for National Accounts. Under the current classification regime that is overseen by the Office for National Statistics, it is likely that the NIB would be classified as a public financial corporation. Under normal circumstances, a body classified as a public financial corporation will have an impact on Public Sector Finance statistics and the UK Government's fiscal targets. This is because in the UK the measure of public debt used by the government in its fiscal targets is 'public sector net debt', which is defined as public sector financial liabilities (for loans, deposits, currency and debt securities) less liquid assets. For the purposes of the definition, the public sector comprises central government, local government and public corporations.

While the UK government targets total debt across the whole public sector, this is not standard practice internationally. Most other countries, including across the EU, monitor and target 'general government gross debt', which includes both central and local government but excludes public corporations—including state investment banks. The Office for National Statistics also publishes this measure every quarter, as it is required to under the conditions of the Maastricht Treaty. However, unlike most other countries, HM Treasury does not use this measure to set domestic fiscal targets – instead it chooses to use the 'public sector net debt' measure.²⁴⁰ So while across Europe state investment banks such as the German KfW and the Italian Cassa di Risparmio di Roma can borrow and invest prudently without clouding the debate about the public debt and deficit, a UK equivalent could not.

This illustrates the somewhat unusual and arbitrary nature of the UK's approach to setting fiscal targets. We therefore recommend that HM Treasury aligns the measure of debt and deficit it

uses for fiscal targets to the general government measure used in other countries, and which is already measured and published by the Office for National Statistics. The case for doing so is strong: there is a qualitative difference between general government borrowing because spending exceeds tax revenue, and an NIB raising funds in capital markets to finance projects that will generate a stream of income in the future.

6.10 State aid

As with the Post Bank, as long as the UK remains part of the EU, or has a comprehensive trade agreement with the EU, it is likely that the NIB will have to comply with EU state aid rules. The European Commission and European Council recently published guidance to Member States intending to set up new NIBs, including in relation to state aid compliance.²⁴¹ The guidance draws on recent decisions by the European Commission to offer insight into how compatibility with State aid rules are assessed. These include the UK's Green Investment Bank and British Business Bank, the Portuguese Development Financial Institution and the Latvian Single Development Institution. In those decisions, significant emphasis was placed on the need to ensure that the NIBs will focus their operations on sectors where market failures are pervasive and which are underserved or not served by private providers. Commercial activities had to be separated from promotional activities in order to avoid cross-subsidisation.

Significantly, governments were encouraged to make the NIB intervene indirectly via financial intermediaries in order to reduce risks of crowding out and discrimination among private finance providers. However, it is notable that although the British Business Bank conducts most of its lending through intermediaries, the EU Commission's state aid ruling did give it permission to invest in firms directly under certain circumstances.²⁴²

If the NIB has to comply with EU state aid rules then it is recommended that it engages with other European NIBs, such as Germany's KfW and France's Bpifrance, to learn how to navigate the state aid regime most effectively.

7 CROSS-CUTTING ISSUES

7.1 Interaction with incumbent commercial banks

New public banks will not exist in a vacuum, and their interaction with the UK's existing highly concentrated banking system therefore needs to be considered. There are a number of aspects to this. Firstly, the dominance of these banks in terms of market share, and the fact that we know most customers do not switch banks readily, constitutes a significant barrier to a new Post Bank growing a customer base. Secondly, big universal banks still enjoy a number of implicit advantages over smaller and more specialised banks, including an implicit 'too-big-to-fail' subsidy from the taxpayer through lower costs of borrowing,²⁴³ and a regulatory system that favours their complex and highly diversified business models (for instance, in the design of capital requirements or the way regulators view applications for new banking licenses). Thirdly, big banks control many of the functions which new public retail banks will rely on to operate. These include the payments system as well as investment banking services. Finally, it is possible that the establishment of new public banks could have unforeseen ripple effects on the business models of existing large banks, for instance if they were pushed towards more risky activity or aggressive mis-selling to maintain profits and market share.

This means that the establishment of new public banks should not be seen in isolation from, or as a substitute for, measures to reduce the unfair advantages and constrain the socially damaging activities of existing large banks. On the contrary, the two must go hand in hand. Setting out a detailed agenda on this front is outside the scope of this report. However, below we highlight some specific avenues that should be considered if the recommendations in this report are to be delivered effectively.

Firstly, the government should consider the potential for publicly owned alternatives to the services currently controlled by incumbent banks. As far as the payments system goes, steps should be taken to ensure that the Post Bank has direct access to the payments system, and does not have to rely on one of the large incumbent banks

to clear its payments. As for investment and asset management services, the German Sparkassen relies on the publicly owned Landesbanken and DekaBank to provide these for the local retail banks. Setting up an equivalent institution in the UK to support the Post Bank network would likely be too complex and costly for this initial phase of reforms, but could be a longer term objective.²⁴⁴ In the short term, this means that the network will be directly interconnected with the rest of the banking system – both dependent on it and, ultimately, exposed to some of the risks it may generate.

Second, the principle of requiring big incumbent banks to support the Post Bank and other public-interest banks need not be confined to RBS. It could be extended, not just to Lloyds Bank (which also enjoyed a taxpayer bail-out) but to all the UK's largest banks. Labour have already committed to reversing recent cuts to the Bank Levy, but it could be argued that the levy should be increased to reflect the implicit subsidy they receive, and that the proceeds should be ringfenced to provide capital investment and capacity-building support for the Post Bank and other new public-interest banks.

Similarly, debate continues to rage over the Access to Banking Standard (previously the Access to Banking Protocol), which has proved largely ineffectual in preventing banks from closing branches that could be viable, leaving communities without adequate access to alternative banking services.²⁴⁵ Labour has already said that it would replace the Access to Banking Standard with legislation to prevent further branch closures.²⁴⁶ However, a Labour government could go further by passing legislation requiring any bank that closes the last branch in town to make its premises available to the Post Bank to open a new branch, or to contribute to a fund providing support to the Post Bank to build and maintain universal branch coverage.

Longer term, changes to the regulatory regime may well be desirable to tilt the playing field back towards desirable public interest banking models, which are disadvantaged by the current regime. Some of the relevant regulations, such as

capital requirements, originate from international agreements, adding a layer of complexity to achieving this. More work is needed on the detail of this regulatory reform agenda, and this should be an area for future research.

7.2 Interaction between public banks and other stakeholder banking models

It is worth noting that a reformed RBS and a Post Bank would be competing in some of the same markets. However, the scale of the UK banking market's failure, particularly with regards to SME lending, is such that it will be possible for both to operate profitably alongside each other. Moreover, under any scenario, RBS would remain a significant competitor to the Post Bank for retail business, and reform of the bank to turn it into a responsible competitor rather than an irresponsible one could well benefit the Post Bank.

Similarly, the Post Bank could find itself in competition with initiatives to create other new types of local stakeholder banking in the UK, such as the Co-operative Savings Bank Association (CSBA), and community banking initiatives such as Hampshire Community Bank. In other countries, public and co-operative banks exist side-by-side, and there is evidence that this dynamic has benefits for the system as a whole in terms of financial stability, economic resilience and customer service.²⁴⁷

Care should be taken to ensure that the success of these two types of bank does not become a zero sum game, with each taking business from the other rather than from the existing big banks. Such an outcome would threaten their financial viability and have negative implications for the diversity and resilience of the banking system. We therefore recommend that **cultivating a diverse stakeholder banking ecosystem and growing its market share** should become a key aim of Labour's industrial strategy, and progress against this aim should be monitored closely. This goal could then be supported through a number of policy levers such as the use of NIB on-lending and the incentivised transfer of existing customers from RBS and other big banks. Competition policy in banking could also be reviewed to consider diversity of provision, not just market share, as has been recommended by the New Economics Foundation.²⁴⁸

7.3 Skills development

As noted in section 3.1 above, there is an acute shortage of skills in relationship-based lending in the UK banking system. As big banks have become increasingly centralised and reliant on credit scoring algorithms, their local staff relegated to little more than salespeople, these skills have been lost. As one expert we spoke to put it, "Lending skills, relationship building, understanding businesses is something that ... there are far fewer people who can do that now". This is not only an issue for the Post Bank, but for reforming RBS to refocus its business model on relationship lending – and indeed for any institutional changes designed to promote the kind of resilient SME lending relationships seen in other countries with large public and stakeholder banking sectors.

It is therefore vital not to underestimate the need for training and skills development for loan officers at the local branch level, as well as the need to ensure high quality, competent management at the level of regional and national headquarters. Even with the best-laid plans for governance structures and business models, neglecting this could result in new public banks failing badly in the early years, and this being seen as evidence that the model cannot work. **We recommend establishing a skill sharing partnership with international banks that have successfully developed this model, such as the German Sparkassen, and making a concerted effort to recruit relevant expertise from overseas.**

7.4 Alignment with Labour's wider investment strategy

Labour has indicated that it will establish a Strategic Investment Board (SIB) that will bring together the Chancellor, the Secretary of State for Business and the Governor of the Bank of England.²⁴⁹ The Strategic Investment Board will be charged with delivering a major increase in productive investment across the whole country, focused on the fourth industrial revolution.

It is important that the proposals outlined in this report are fully aligned with Labour's broader investment strategy so we recommend that Labour consider how the public banking network we have recommended here would be integrated into the framework for delivering SIB recommendations and the required increase in productive investment.

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