



## **Our friends in the City**

Why banking's return to business as usual threatens our economy



## **New Economics Foundation (NEF)**

is an independent think-and-do tank that inspires and demonstrates real economic wellbeing.

We aim to improve quality of life by promoting innovative solutions that challenge mainstream thinking on economic, environmental and social issues. We work in partnership and put people and the planet first.

# Contents

Summary	2
Recommendations	4
Introduction	5
1. Return to business as usual: Why the UK remains vulnerable to a crash	7
2. Asset or liability: Why the City isn't good for the economy	14
3. Threats to leave: Why policymakers should not give in to bank blackmail	24
Conclusion	26
End notes	27

## Summary

Our banking system is still dangerously dysfunctional. Post-crisis reforms failed to fully address the risks posed by the City of London, and with banks back in the driving seat, these reforms are already being rolled back. We cannot afford a return to business as usual.

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The UK has one of the biggest, most concentrated, risky, complex, and interconnected banking systems in the developed world. It leaves us uniquely exposed to global financial turmoil.

If post-2008 promises to reform our financial system had been kept, the dangers we face now would not be so acute. Instead, UK banks have fast-tracked a return to business as usual. Contrary to recent claims by policymakers, post-crisis reforms did not fix the structural problems with our banks. Recent concessions to the City are already rolling back the limited progress made:

- **Banks are still at risk of failing.** Measures to increase banks' capital do not go far enough, and in any case they misdiagnose the problem: financial crises are created within the financial system. More must be done to change the business models behind our banks' risky behaviour.
- **UK taxpayers remain on the hook.** Banks remain too big to fail, and as a result, continue to receive £5.8bn a year in implicit government subsidies. The ring fence between retail and investment banking – intended to insulate the taxpayer from losses caused by risky activities – is also being rolled back.
- **The UK banking sector still lacks competition and diversity.** The UK has the second most concentrated banking sector in the G7 – its top 3 banks own over half of all bank assets – and is uniquely dependent on shareholder-owned banks. Recent changes to the bank levy actually undermine competition, as they benefit big, international banks like HSBC at the expense of smaller challengers.

Recent concessions to big banks have been justified by claims that international investment banking is vital to our economy. These claims are grossly exaggerated: our status as an international banking hub is as much of a liability as an asset:

- **The City's contribution to UK growth is outweighed by the damage from financial instability:** Banks' contribution to Gross Value Added (GVA) has consistently fallen since 2008. Financial instability does long-term harm to economies: the losses to UK GDP from the crisis of 2008 have been estimated at up to £7.4 trillion.
- **The City is a weak and unbalanced provider of jobs:** Wholesale banking accounts for just 120,000 jobs, and only 15,000 of those are outside London. UK banks only created 36,000 new jobs in the pre-2008 boom years and have been cutting jobs consistently since 2006.
- **Banks pay even less corporation tax than they did before the financial crisis.** Corporation tax paid by banks has fallen from £8.8bn in 2008 to £3.8bn in 2014, despite a new levy which promised to recoup the costs of bailing out the banks (£289bn in direct costs alone). This fails to cover even the interest payments (estimated at £5bn a year) on these costs.
- **The City is still failing to serve the real economy:** only a small proportion of banks' balance sheets (less than 10%) supports non-financial businesses – the majority is fuelling an unsustainable housing boom in the South East of England. Small business lending is still severely lacking, and the credit banks do provide is regionally unbalanced.

Despite this questionable record, banks continue to threaten to move elsewhere if regulation is designed against their interests. HSBC's recent threat to quit the UK and relocate its headquarters abroad is only the most recent example of such tactics.

This is not a credible threat:

- **London remains an attractive proposition to banks** for a whole host of reasons that have little to do with tax or regulation and are difficult to replicate elsewhere, from the time zone to the global language.
- **Even if banks' threats were followed through, the impact would not be as disastrous as we are led to believe.** Only a fraction of the jobs and taxes provided by UK banks would actually need to move given a relocation of headquarters – and there would be benefits as well as costs, most obviously a reduced exposure to global financial shocks.

We cannot afford a return to business as usual. Given their overstated contributions to the UK economy, and the real liabilities the City of London represents, threats to leave unless given concessions can and should be faced down. The interests of big banks should not come before those of the rest of the economy.

## Recommendations

We recommend:

- **The Bank of England should significantly strengthen the lightweight ring-fencing regime.** An urgent clamp down is needed on ring-fenced banks' economic links with the rest of their banking group. If banks continue seeking to water down and 'game' the regulation, full structural separation between retail and investment banking must be reconsidered.
- **The Financial Policy Committee should consider more active credit guidance policies.** More active intervention could stimulate real economy lending and dampen down both mortgage lending and lending to other financial corporations.
- **The Treasury should urgently review options for addressing the lack of diversity in the UK banking system,** and for promoting a more vibrant local stakeholder banking sector. This should include examination of the full range of options for the public's majority stake in the Royal Bank of Scotland (RBS).

## Introduction

In his 2015 Mansion House speech, George Osborne spoke of a 'new settlement' between policymakers and the City. Banks must no longer be seen as 'part of the problem', but as 'part of the solution'.

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Post-crisis reforms had, he said, made 'enormous progress' in solving the problems exposed in 2008, and the focus must move back to 'ensur[ing] we have the best, and most competitive financial services in the world', and making Britain 'the best place for European and global bank HQs.'<sup>1</sup> In December 2015, the Bank of England's Financial Policy Committee declared that the 'post-crisis period' was over, in a statement which was widely interpreted as a further softening of regulators' stance towards the banks.<sup>2</sup>

These remarks have set the tone for a string of concessions to big banks, including:

- Changes to the bank levy which benefit large international banks such as HSBC at the expense of smaller challenger banks;
- The sacking of Martin Wheatley as Chief Executive of the Financial Conduct Authority (FCA), a move which has been followed by a number of inquiries and investigations being dropped;
- A watered-down set of proposals for implementing the ring fence between retail and investment banking, particularly in relation to economic links with the rest of the group;
- A disappointingly weak report from the Competition and Markets Authority, which rules out action to break up big banks and instead focuses on consumer switching behaviour;
- Confirmation by the Bank of England that banks will not be asked to hold significantly more capital;
- Imposing a time-limit on claims relating to mis-selling of payment protection insurance (PPI).

But is this change of mood justified? In this paper, we take stock of the UK's progress since 2008 and find that each of the key claims underpinning the 'new settlement' is flawed:

- Post-crisis reform has failed to address the risks posed by the UK's big banks.
- The benefits of the City's international status to the UK economy have been vastly overstated: in fact, our broken banking system is more of a liability than an asset, and fixing it would be good for our national prosperity.
- Threats by banks such as HSBC to leave the UK unless they are given concessions on tax and regulation can and should be faced down.

With the global economy facing a slowdown and economists warning that another crash could be just around the corner, it is more urgent than ever that we address the shortcomings of post-crisis reform and the continuing dysfunctionality of the UK banking system. Deregulation and a return to business as usual is precisely the wrong prescription.



# 1. Return to business as usual: why the UK remains vulnerable to a crash

Underpinning the shift back towards 'light touch' regulation is the claim that post-crisis reforms have done enough to protect us from another financial crash, and that we may even have gone too far in our quest to stabilise the system. In this section we examine this claim and find that it is dangerously complacent.

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As NEF's Financial System Resilience Index has shown, the UK still has one of the biggest, most concentrated, least diverse, most risky, most complex, and most interconnected banking systems in the developed world.<sup>3</sup> This is largely because of our reliance on a small number of large international banks which operate in a highly complex, highly connected network of other financial firms, whose activities overwhelmingly face each other rather than the real economy.

Relatively minor events can quickly turn into major financial shocks as they reverberate around this network – as we saw in 2008, and as we saw in early 2016 with dramatic stock market falls and violent moves in bond yields. The UK's domestic economy is almost uniquely exposed to such events: for example, UK banks have the highest exposure to China of any national banking system except China itself – 'UK-owned banks' exposures to Greater China total \$540 billion or 100% of core capital'.<sup>4-6</sup>

In the remainder of this section we explore in more detail how post-crisis reforms have failed to directly address these problems – and how recent concessions to the banking lobby are already rolling back the limited progress made.

## **Making banks safer**

### *The claim*

New EU and UK regulations requiring banks to hold more capital have made our banking system more resilient. Stress tests show that banks now have enough capital to cover their losses in the event of a crisis scenario: effectively, banks are no longer at risk of failure.

### *The reality*

An OECD study showed that the 69 largest US and European banks, which had \$1.6 trillion in combined capital in 2009, would have required an additional \$4.5 trillion – almost a quadrupling – to remain at a safe level during the crisis.<sup>7</sup> New capital requirements have stabilised well below this level. By 2019 the big four banks will have to hold capital of at least 11% of the risk-weighted value

of their loans.<sup>8</sup> This is less than some have now, and much less than many regulators predicted would be necessary immediately after the crisis.

In any case, as Finance Watch points out, relying on capital requirements to prevent banks failing is highly dangerous. 'The biggest banks need very little capital in good times but can never have enough capital in a system wide stress (the so-called regulators' paradox) [...] Hence no reasonable ex-ante amount of capital will protect the biggest trading-oriented banks from failing.'<sup>9</sup> Individual bank stress tests do not give us a truly accurate picture of how banks would fare in a systemic crisis scenario as a shock cascaded around the system. This is particularly true for the UK given our banking system's high level of interconnectedness.

Highly complex risk-weighted capital requirements also place far too much reliance on risk models, which the 2008 crisis showed are at best a poor predictor of uncertain events, and at worst an active contributor to instability (as banks 'herd' into assets with a lower risk weighting, and regulators are given a false sense of security). They may also impede competition and diversity by imposing a disproportionate burden on smaller and more specialised banks which are not the source of systemic risk.

Finally, this approach to 'making banks safer' treats financial shocks as something external that happens to banks, and which they must protect themselves from – rather than as something generated by banks through excessive lending, inflating asset price bubbles, and risky business models focused on intra-financial trading. This means that post-crisis regulation has fundamentally failed to address the underlying problems which caused the crisis in the first place.

#### *The 'new settlement': easing off on capital*

In October 2015, the Bank of England confirmed that it **would not raise baseline capital requirements** any further, in a move which was widely interpreted as a sign of regulators relaxing their approach to the big banks. It has also yet to impose a 'counter cyclical buffer' – a tool requiring banks to hold more capital in good times and less in bad times – despite warnings that mortgages and consumer credit are once again being over-extended.<sup>10</sup> The Bank, however, hinted that the buffer might be imposed this year. Sir John Vickers, Chair of the Independent Commission on Banking (ICB), recently expressed concern that capital buffers for UK retail banks were still insufficient to protect them from a systemic shock.

#### **The 'too big to fail' subsidy**

##### *The claim*

Even if banks do fail, they will not need to be bailed out by the taxpayer. New 'bail-in debt' provisions are intended to ensure that bank losses are borne by creditors rather than the taxpayer.<sup>11</sup> The ring fence between retail and investment banking is supposed to insulate 'core' banking functions from speculative activities, meaning that the latter can safely be allowed to fail. We are told that we can now have the best of both worlds: 'being a host for global finance without exposing our taxpayers again to the calamitous cost of financial firms failing'.<sup>12</sup>

### Box 1. What is the TBTF subsidy?

Large banks are said to enjoy an 'implicit subsidy' from being too big to fail (TBTF). This does not refer to the actual cost of taxpayer bailouts, but the fact that these banks can borrow more cheaply on international markets because lenders believe they are protected by an implicit state guarantee, and are therefore a safer investment than might otherwise be the case. This may be not just because of their size, but the impact their failure would have on the wider economy – for example, because of their interconnectedness with the rest of the financial system, their role in providing essential payment facilities, or the need to protect customer deposits.

#### *The reality*

There are several reasons to think that bail-in (or 'recovery and resolution') measures will not prevent the state having to step in during a systemic crisis. First, if 'bail-in bonds' are predominantly held by pension funds, insurance companies and other financial institutions, bank losses will still ultimately be borne by ordinary citizens. Secondly, if losses exceed the amount of equity and bail-in-able debt the losses will still have to be borne by someone - either depositors or the state. In both cases politicians may conclude that the costs to the wider economy are unacceptable and offer bail-out rather than bail-in.

After all, the law in 2008 also stipulated that losses would be borne by equity and bond holders in the case of default, but politicians deemed the risks of imposing all these losses too great. If banks have not fundamentally changed there is every reason to think the state will once again step in during a crisis. Indeed, in Greece, bank restructuring with EU bail-out funds was rushed through before the new bail-in rules were implemented. Politicians side-stepped the new rules because they would have imposed losses, most likely including some depositors, which were felt to be politically and economically unacceptable.<sup>13</sup>

New NEF analysis shows that markets also seem to believe the state will ultimately step in to protect failing banks: UK banks still enjoy a significant TBTF subsidy. In 2012, NEF calculated the TBTF subsidy to be worth around £37.5 billion to the big four British banks. Since then the yields for banks in the UK and around the world have decreased significantly as the immediate threat of bankruptcy has been perceived to be receding. As a result, using the same calculations today gives a TBTF subsidy of £5.8 billion. While much smaller than in 2012, this figure remains larger than the combined after-tax profits of the big four banks in the first six months of 2015. It is also more than the £5.2 billion the UK spent on renewables subsidies in 2015/2016.

There is also strong evidence that little has fundamentally changed. Most of the fall in the TBTF subsidy is explained by the fall in yields – largely attributable to central bank interventions, in particular Quantitative Easing – rather than by changes in banks' credit ratings. In other words, it can be attributed to changed economic conditions rather than changed perceptions of risk due to more effective regulation. It is also worth noting that rating agencies continue to rate banks' standalone creditworthiness as worse than their actual creditworthiness, reflecting an assumption that at least some creditors will receive additional state support in the event of bank failure.

In order to see how banks would fare if yields rose again, we calculated the TBTF subsidy using 2015's balance sheet but 2012's bank yields. Despite the banks' improved credit ratings, we found that the TBTF subsidy would be £30.7 billion, not far from its actual level in 2012. If anything, this is likely to be an underestimate. The TBTF subsidy in the event of a new crisis would almost certainly be higher, as banks would be downgraded by the rating agencies. In other words, if market conditions were to change, there is every reason to suggest that the banks would again be spared the full cost through implicit or explicit support from the state – and that this could be worth as much as it was in 2012.

**Table 1. Potential size of TBTF subsidy for the big four UK banks: scenario analysis**

	2007	2015 banks with 2007 yields	2012	2015 banks with 2012 yields
Barclays	£2,574	£5,668	£11,744	£10,093
RBS	£3,261	£729	£11,499	£8,011
HSBC	£2,583	£2,088	£4,682	£4,051
Lloyds	£1,120	£3,448	£9,605	£8,577
<b>Total</b>	<b>£9,538</b>	<b>£11,933</b>	<b>£37,529</b>	<b>£30,731</b>

Figures in millions of pounds.

Source: Moodys, 2015 half-year financial reports of respective banks, Merrill Lynch Sterling Financial Bond Indices, own calculations

### *The 'new settlement': rolling back the ring fence*

'Internal separation' of big banks' retail arms from their investment arms was supposed to address the TBTF subsidy. But the decision to opt for a complex regulatory solution rather than a simple structural one (full separation) always ran the risk that the benefits of the regime would be 'hollowed out' by bank lobbying during the long implementation period. Recent developments are bearing out these concerns.

In October 2015, the Prudential Regulation Authority published implementation proposals which were described variously by reporters as 'a boon for the UK's largest lenders'<sup>14</sup> and 'a ringfence with a gate'.<sup>15</sup> One lawyer commented: 'They have taken [the reforms] back to the limit and gone as far as they could to make life easier for the banks within the framework of the law.'<sup>16</sup> The proposals made two key concessions:

1. Ring-fenced retail banks will now be able to **pay dividends to their investment banking arms** – enabling big universal banks to cross-subsidise loss-making investment banking activities with 'excess profits' from retail customers. The original legislation required the Prudential Regulation Authority (PRA) to make rules limiting such payments, but banks had complained that this would put them at a competitive disadvantage to overseas rivals.

2. The proposed rules also impose **minimal restrictions on retail and investment banking arms** within the same group lending money to each other – including collateralised lending, which was a major contributor to the financial crisis – and on cross-selling their products to the same customers (thus making the two businesses financially interdependent).

Banks will only have to show that they are meeting regulatory capital requirements, and that they have policies and procedures in place to assess and manage the risks posed by links with the rest of the group. But the financial crisis taught us the dangers of relying on banks' own ability to predict and manage risks in an uncertain world – especially when they face strong incentives to ignore or downplay those risks to enhance short-term profitability. Moreover, even if we accept the policy on its own terms, it is far from clear that the capital buffers in question are high enough to bear the weight being placed on them, as Sir John Vickers has argued.

These moves undermine the intent of the ring fence to ensure that risky speculative activities could not be subsidised by core retail banking activities – and thus implicitly by the taxpayer. The Independent Commission on Banking (ICB) Final Report noted that a 'relatively high fence is required to secure the benefits of the ringfence' and that even banks that opposed ring-fencing in principle generally agreed that 'if one were to be implemented, significant constraints on economic links with the rest of the group would logically be required'.<sup>17</sup> The current proposals ignore these insights.

Perhaps more importantly, the concessions have major implications for the structure of the system. First, they dramatically reduce the incentive for big banks to voluntarily split themselves – which some had hoped would be an outcome of the ring-fencing regime, thus enhancing diversity and creating genuinely independent retail banks with safer funding and business models. And secondly, they will do little or nothing to limit the interconnectedness between retail and investment banking arms – so big universal banks can still act as 'super spreaders' of contagion during a crisis scenario.

## Competition and diversity

### *The claim*

Policymakers and regulators are focusing relentlessly on improving competition in the banking sector. Over the coming years, these efforts will ensure we have 'more competition, more innovation and more players in retail markets – offering customers a better service'.<sup>18</sup>

### *The reality*

The UK still has the most concentrated banking sector in the G7 after Canada, with the Top 3 banks owning over half of all bank assets.<sup>19</sup> And the Competition and Markets Authority's (CMA's) recent investigation concluded that the current account market remains highly uncompetitive, with many customers still getting a raw deal.<sup>20</sup> On average, those in credit could save £70/year by switching, overdraft users £140/year, and heavy overdraft users £260/year. The four largest banks accounted for approximately 70% of active personal current accounts (PCAs) and 80% of active business current

accounts (BCAs) in 2014. They also accounted for 80% of outstanding loans to small and medium enterprises (SMEs) and 87% of business credit cards. Alternative funding sources for SMEs (such as peer-to-peer lending) remain tiny despite rapid growth in recent years – less than 2% of SME funding.

But it is not enough to focus only on competition. After all, as the Parliamentary Commission on Banking Standards has pointed out, UK banks 'competed' fiercely in the run-up to the financial crisis: the problem was that they were competing to please their shareholders by posting bigger quarterly profits and higher returns on equity, rather than to serve their customers by offering a better service.

What we need is not just more banks, but more banks that are genuinely capable of putting customers first rather than shareholders. As John Kay has put it: 'There is less of a need for more banks than there is for more *diversity* of banks [...] the essence of competition is not just that several people do things. It is that people try to do things differently.' Improving the diversity of the banking sector was an explicit objective of both the Coalition government and the previous Labour government – but, as the 'D-Index' of corporate diversity in banking shows, this measure has actually worsened significantly since the crisis, as a number of large banks collapsed or were bought up by other players, and the Co-operative Bank became shareholder-owned.<sup>21</sup>

#### *The 'new settlement': protecting the incumbents*

The rhetoric of improving competition is belied by the **weakness of the remedies proposed by the CMA's** recent investigation into retail banking. The CMA effectively ruled out structural interventions (such as breaking up big banks), or measures to ban misleading 'free if in credit' current accounts, instead focusing on measures to encourage customers to switch through better provision of information. Evidence suggests this is likely to be ineffective: the introduction of the current account switching service has failed to meaningfully affect the level of customer switching, which fell back to just 3% in 2014 after an initial rise.<sup>22</sup>

The CMA argued that splitting up large incumbent banks 'might simply create two smaller banks, each with a high proportion of inactive customers paying relatively high prices'.<sup>23</sup> The obvious answer to this is that we need measures to promote different types of bank, not just more banks – and in particular, stakeholder banks that are genuinely capable of putting customers' needs first. Instead, the CMA is continuing to place the onus on customers to shop around for a better deal in what it admits is a dysfunctional market. There is no international evidence that banking systems where customers regularly switch accounts enjoy better outcomes.



In addition, despite government rhetoric, recent policy changes if anything hinder competition and entrench the advantages of incumbents. For example, the 2015 Summer Budget announced the phasing out of the **bank levy**, which was targeted at the biggest banks and levied in proportion to their balance sheets, to be replaced by a new 'Bank Corporation Tax Surcharge', which hits smaller banks for the first time and is not proportionate to size. This directly benefits large international banks such as HSBC and Santander at the expense of smaller challengers – indeed, the change was widely interpreted as a lobbying victory for HSBC,<sup>24</sup> while challenger banks have mounted a vocal, but so far unsuccessful, counter-lobby.<sup>25</sup> The Treasury Select Committee has called on the CMA to investigate the competition impacts of the change.<sup>26</sup>

### **Conclusion: sleepwalking into another crisis?**

As we have seen, efforts to make individual banks safer, to enable them to fail without taxpayer bailouts, and to promote competition have all failed on their own terms. But perhaps more importantly, they have failed to address the fundamental structural problems with the UK banking sector: its size and complexity, its lack of diversity, and its dependence on highly interconnected shareholder-owned banks with risky funding and lending models. Moreover, it is increasingly clear that bank lobbyists are setting the policy agenda: not only is there little appetite for further reform, but the limited progress made since the crisis is already being rolled back. As the global economic outlook worsens, there is a real danger that the UK is sleepwalking into another financial crisis.

## 2. Asset or liability: why the city isn't good for the economy

Recent concessions to big banks have been justified by claims that international investment banking is vital to our economy. But these claims are grossly exaggerated. In this section we explore why our status as an international banking hub is as much of a liability as it is an asset.

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We have seen that the first claim behind the 'new settlement' – that post-crisis reforms have fixed our banking system – is highly dubious. Here, we explore the second claim: that London's status as an international banking centre is vital to the British economy and that there is thus a trade-off between financial stability (which requires regulation) and economic prosperity (which requires deregulation to maintain our 'competitiveness'). This is used to argue that, having stabilised the system, we now need to redress the balance – or risk losing big banks and the jobs and taxes they provide.

In this section, we show how this story is flawed because:

- It focuses on the economic benefits of international investment banking as a sector in its own right, rather than on banking as a utility serving the domestic economy.
- These benefits are vastly overstated – indeed, taking everything into consideration, the City's international status may be more of a liability than an asset.
- The factors which make our mega banks unstable are the very same ones which make them poor servants of the domestic economy.

Reducing our reliance on banking as a sector, and instead building a banking system which can properly fulfil its functions as a utility, would benefit our economy, not harm it.

### **Banking as a sector: powering the economy?**

The UK banking industry can be considered as two separate banking sectors: domestic retail banking and international, mainly financial-markets-oriented, investment banking. The usual way in which a country's banking sector contributes to the economy is by using depositors' money to expand credit to businesses and households, thereby facilitating economic activity. In the UK, the banks argue that their international trading business is in effect a sector all of its own which contributes jobs and growth to the UK's economy. Indeed, the contribution of this sector is so great that it must be protected at almost



any cost. A recent report from the British Bankers' Association (BBA), *Winning the Global Race*, warns ominously that:

*We have now reached a watershed moment in Britain's competitiveness as an international banking centre ... We have to act now together with regulators and government to maintain the UK's leading position in the global competitiveness race and deliver the 'new settlement' outlined by the Chancellor.*

In other words, post-crisis regulation is beginning to pose grave threats to the UK's prosperity by making us an uncompetitive location for international banking activity. If banks do not get their way, they can easily move their headquarters overseas – with catastrophic consequences for our prosperity. But how convincing are these claims?

### **Claim: international banking is vital to GDP**

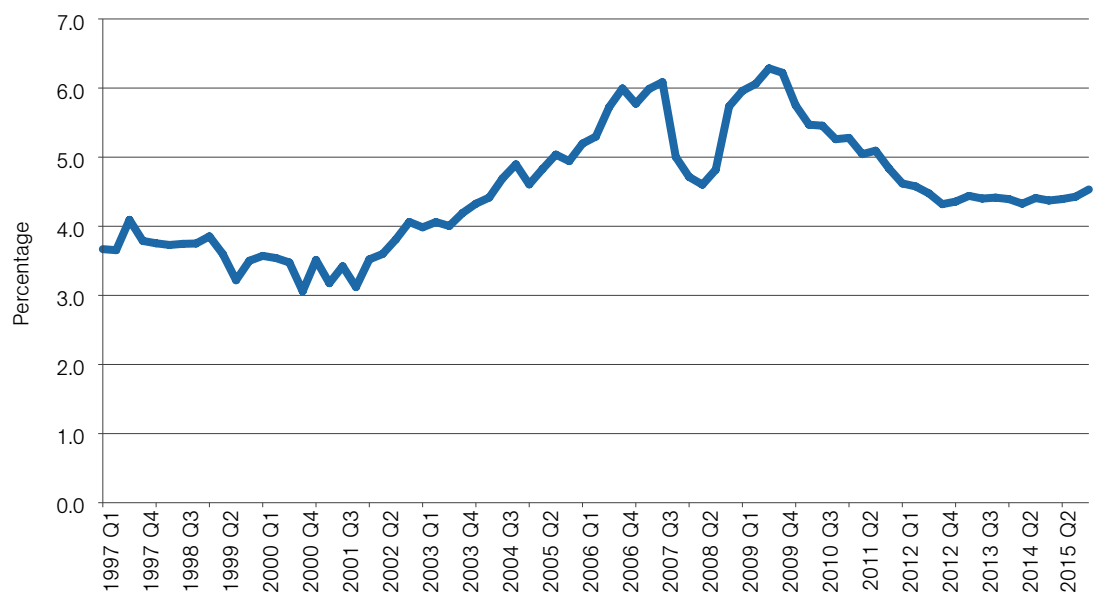
#### *Claim*

The BBA claims that international wholesale banking provides 'almost 5% of Gross Value Added (GVA)', with international banks responsible for more than 50% of this.<sup>27</sup> Look a little closer, however, and several problems can be seen with this claim – the City's international business is not as valuable to the economy as it likes to make out.

#### *Reality*

First, banks' contribution to GVA is falling and has been since 2008 (Figure 1). Banks might argue that this can be blamed on post-crisis regulation. A common sense view, however, would suggest that this is more likely to be a structural trend due to the City's over-expansion during the boom years and the resulting economic downturn.

**Figure 1. Financial service activities, except insurance and pension funding**



Source: ONS

## Box 2. Banking in GVA

Banking's contribution to GVA is mainly calculated by 'the interest rate margin between the lending (deposit) rate and a short-term risk-free reference rate, multiplied by the value of the stock of loans (deposits)'. As can be seen in Figure 1, the Financial Services share of GVA appears to rise in 2009, when the bank crisis was in full force. Actually this merely reflects the growing spread between interest rates as a result of the banking crisis and the widespread panic in the financial markets.

In any case, there are reasons to doubt whether banks' contribution to GDP is a useful measure of their economic value.

First, there are doubts about the measurement methodology. As Andy Haldane of the Bank of England has stated: 'As currently measured, it seems likely that the value of financial intermediation services is **significantly overstated** in the national accounts.'<sup>28</sup> European Central Bank (ECB) researchers came to a similar conclusion.<sup>29</sup> Suggested changes would reduce the relative weight accorded to banks and shift it to the rest of the economy.<sup>30</sup> After all, we might be better served to think of banks as a utility for the rest of the economy, which produces economic output.

More recently, an independent review of UK economic statistics commissioned by the government also noted problems with the measurement of banking's contribution, calling a major component 'nonsensical'.<sup>31</sup> See Box 2 for more on how banking's contribution to GVA is calculated and the problems with it.

Perhaps more fundamentally, we must ask if GDP is a good measure of the health of the UK economy. NEF recently argued that GDP growth was masking a sick and unbalanced economy, most notably hiding rising unsecured borrowing by households; rising house prices vs average earnings, especially in London; stagnant or falling average real earnings, weak, or even falling, productivity and falling investment as a share of GDP.<sup>32</sup>

Looking wider still, GDP does a bad job of measuring the welfare of society. In place of GDP, NEF has recommended five headline indicators of national success: good jobs, wellbeing, environment, fairness, and health.<sup>33</sup> It seems unlikely that trading floors are contributing much to these measures.

Finally, and perhaps most damning of all, the BBA makes no mention of the economic losses the UK suffered as a result of the financial crisis caused in part by the City's international banking and financial markets business. Estimates of the GDP loss as a result of the crisis and ensuing recession, fuelled in part by the crunch in bank lending to productive firms, range from £1.8 trillion and £7.4 trillion (depending on how permanent the effects of the crisis were).<sup>34</sup> New research by the Bank for International Settlements (BIS) suggests the figure is more likely to be higher than lower and that credit booms and busts inflict long-term damage on economies: 'First, credit booms tend to undermine productivity growth ... Second, the impact ... is much larger if a crisis follows.'<sup>35</sup> Andrew Haldane has pointed out that the total loss of income and output caused by the banking crisis was equivalent to a World War.<sup>36</sup>

## Claim: International banking is vital to job creation

### Claim

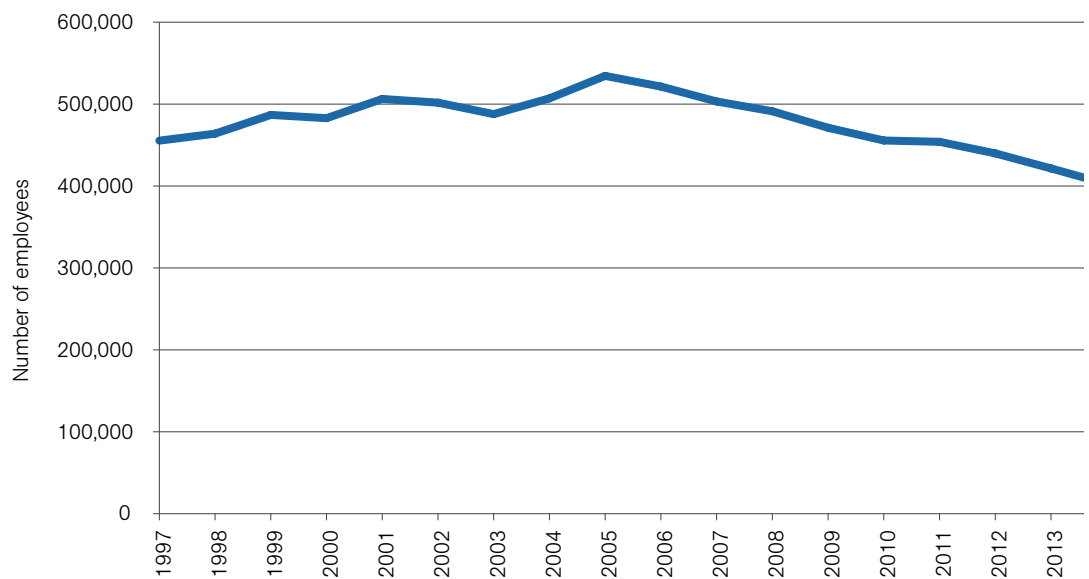
The BBA claims that UK banking employs 405,000 people, with international banks responsible for over 30% of this – using this to suggest that the City is vital to UK employment, and that curbing its international activities would hit job creation.<sup>37</sup> It notes that employment in the UK banking sector has fallen 8% since 2011, suggesting that this reflects 'erosion of the UK's attractiveness as an international banking centre' due to excessive regulation.

### Reality

First, the BBA deliberately conflates the jobs created by internationally mobile investment banking with those in domestic retail banking. Once we examine the two sectors separately, its own figures do not support its argument. In fact, by its own admission, wholesale banking accounts for only around 120,000 jobs and falling, enough to fill Wembley stadium, but not much more. It estimates that more than double that, around 250,000, work in retail banking (Figure 4). What's more, these jobs are much more evenly spread around the country: around 245,000 retail banking jobs are outside London, compared to just 15,000 wholesale banking jobs.

What then of the claim that the loss of UK 'competitiveness' is causing job losses? Banks are indeed steadily employing fewer and fewer people, as Figure 2 shows. For example, in January, Barclays announced a new wave of job losses, some in London.<sup>38</sup> But a closer look suggests that this trend is structural rather than a result of new regulation, and is linked to the bad job our banks do in supporting the economy.

Figure 2. UK domestic bank employees



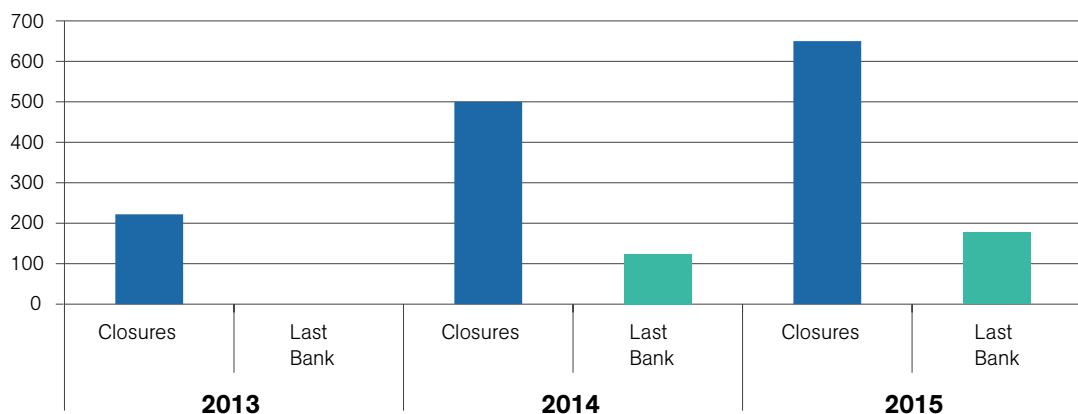
Source: ECB

First of all, the data shows that even during the extraordinary boom of the 2000s, UK banks created very few new jobs (only 36,000 between 1991 and 2007).<sup>39</sup> And, with the exception of 2005/2006, the sector has never since employed more people than it did in 2001. Its contribution to employment was falling even before the crisis.

Ironically, one reason for this may be the rising costs of London in terms of office space and salaries, a trend which is at least in part attributable to the impact of the City's own activities – including an unhealthy and unsustainable property boom. Banks continue to move middle- and back-office functions out of London; some of these move elsewhere in the UK, but many others move offshore.<sup>40</sup> Adding to this trend, standardisation, technology, and central clearing will mean increased automation of back- and middle-office jobs.

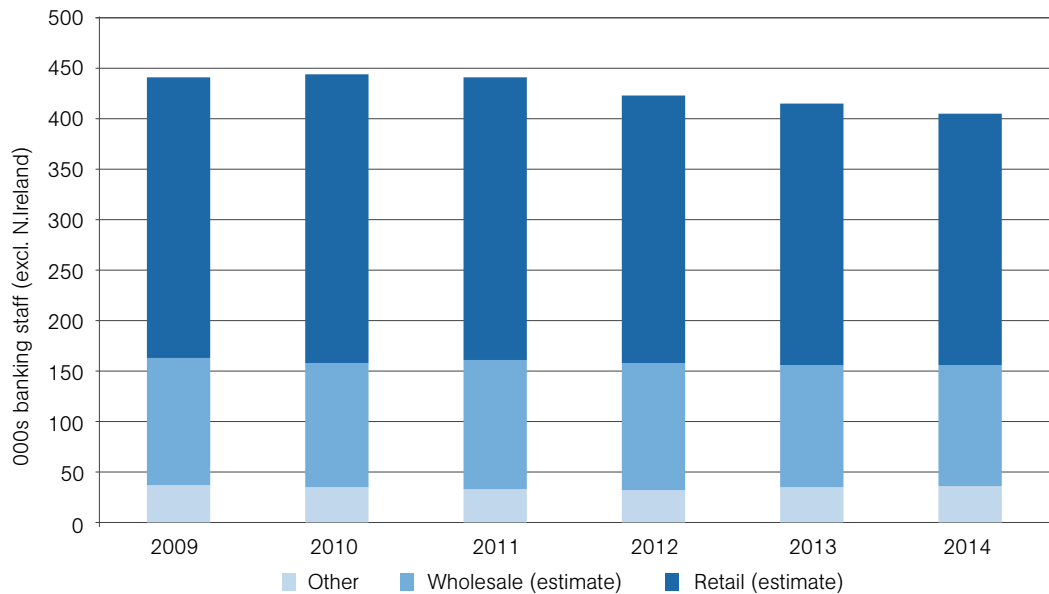
Another reason lies in the banks' own business models, and in particular their increasingly rapid retreat from providing basic high-street banking services. Employment in domestic retail banking is actually falling faster than in international wholesale banking, as banks make use of technology to cut jobs and close branches. In the first three quarters of 2015, UK banks closed 650 branches, of which 177 were the last bank in town. The pace of branch closures has increased dramatically over the past two years (Figure 3).<sup>41</sup>

**Figure 3. UK bank branch closures and 'last bank in town' closures, 2013–2015**



Source: Campaign for Community Banking Services / Unite the Union

The big four banks have all pursued a business model which centralises credit allocation decisions using credit scoring and statistical risk valuation models, and which pushes customers away from branch banking and towards telephone and Internet banking. The result is twofold: fewer and lower quality jobs and more difficult borrowing conditions for SMEs that don't 'fit the model'. For the BBA to point to the resulting job losses as evidence that casino banking should receive an easier ride from regulators is deeply disingenuous.

**Figure 4. UK banking sector employment**

Finally, as with the BBA's other measures of success, this pays no attention to the effects of the crisis. Although overall employment has held up, this has come at a cost. Unemployment in some cohorts/regions remains high; there is considerable under-employment, precarity has increased, and employees are increasingly over-qualified for the work they are doing. Moreover, real wages remain below their pre-crisis peak.<sup>42</sup> As NEF has shown, the proportion of people in good jobs fell between 2011 and 2014.<sup>43</sup>

### **Claim: International banking contributes to the public purse through taxes**

#### *Claim*

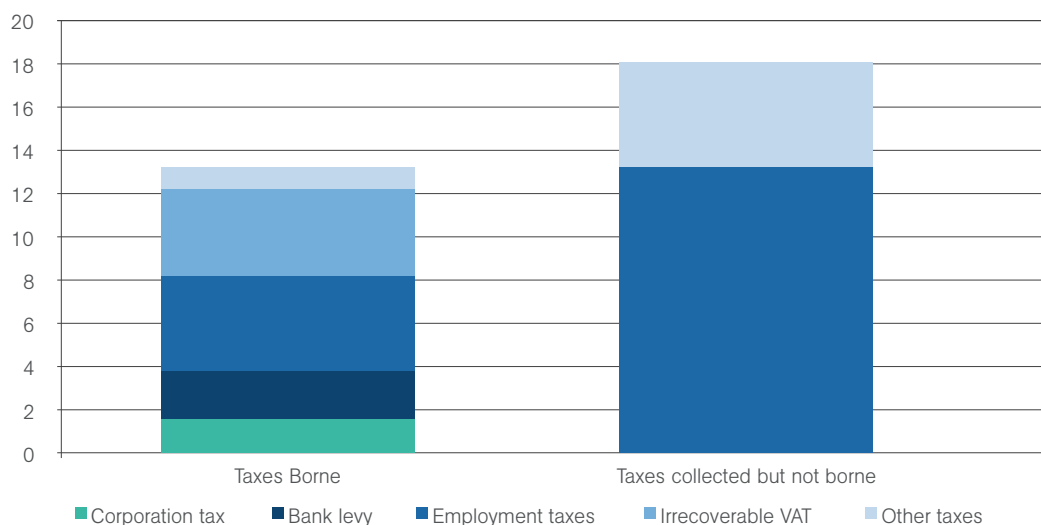
The BBA, based on a study by PricewaterhouseCoopers (PwC), claims that UK banking sector had a Total Tax Contribution (TTC) £31.3 billion in 2014, making up 5.5% of government receipts.<sup>44</sup> Note again that this figure conflates domestic and international banking.

#### *Reality*

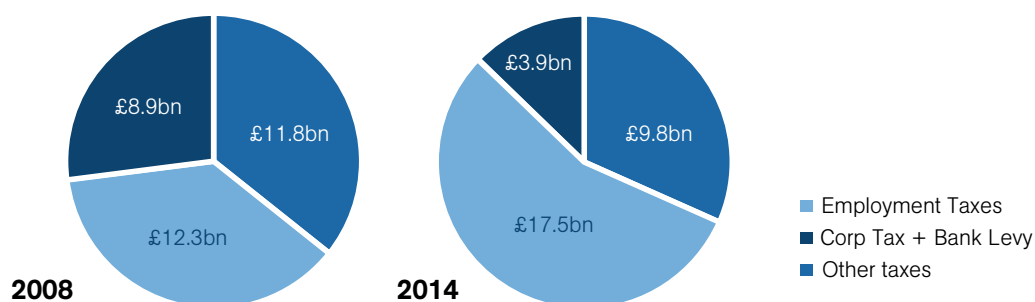
First, as with other measures, the TTC of banks has fallen since 2008 (by around 5%) – despite new measures, such as the bank levy, which we were led to believe were intended to at least partially recompense for the cost of the crisis.

Second, less than half the TTC in 2014 was actually borne by UK banks – PwC estimates £13.2 billion was borne by the sector itself. The rest (£18.1 billion) was borne by others but collected on behalf of HMRC by UK banks.<sup>45</sup>

The combined burden of corporation tax and the bank levy fell dramatically between 2008 and 2014, while the contribution of employment taxes grew, most of which is borne by employees (£13.1 billion out of £17.5 billion in 2014). Not only does this in part shift the tax burden from capital to employees, but it also seems likely to discourage job expansion in the sector.

**Figure 5. UK banks – taxes borne vs. taxes collected but not borne (2014)**

PwC estimates that in 2008 UK banks paid around £8.9 billion in corporation tax, equivalent to around 27% of TTC. By 2014 the total of corporation tax plus the new bank levy had fallen to £3.9 billion (£1.5 billion corporation tax plus around £2.4 billion in bank levy) or around 12% of TTC. Employment taxes rose from £12.3 billion in 2008 to £17.6 billion in 2014 or from 37.3% to 56% of TTC.

**Figure 6. Taxes paid by UK banks (a) 2008 (b) 2014**

Perhaps more importantly, these figures take no account of the costs of the financial crisis to the taxpayer. During the crisis, direct taxpayer support for the banks amounted to £289 billion,<sup>46</sup> with indirect support (i.e., guarantee schemes) of £1.2 trillion.<sup>47</sup> Interest payments alone on the costs of bank bailouts have been estimated at £5 billion per year.<sup>48</sup> In 2014, this was more than the tax take from bank corporation tax and the bank levy combined. To suggest that it is in taxpayers' interests to water down regulations designed to ensure financial stability in order to keep big international banks in the UK is, once again, deeply disingenuous.

Finally, it is worth noting that banks' direct tax contributions must be set against their major role as 'enablers and intermediaries' of tax avoidance.<sup>49</sup> Ironically, one of the key recent signals of the 'new settlement' in action has been the FCA's decision to drop investigations into HSBC's role in enabling tax evasion via its Swiss subsidiary.<sup>50</sup> In other words, arguments about the tax contribution of UK banks are being used to justify turning a blind eye to activities which actually reduce the tax take.

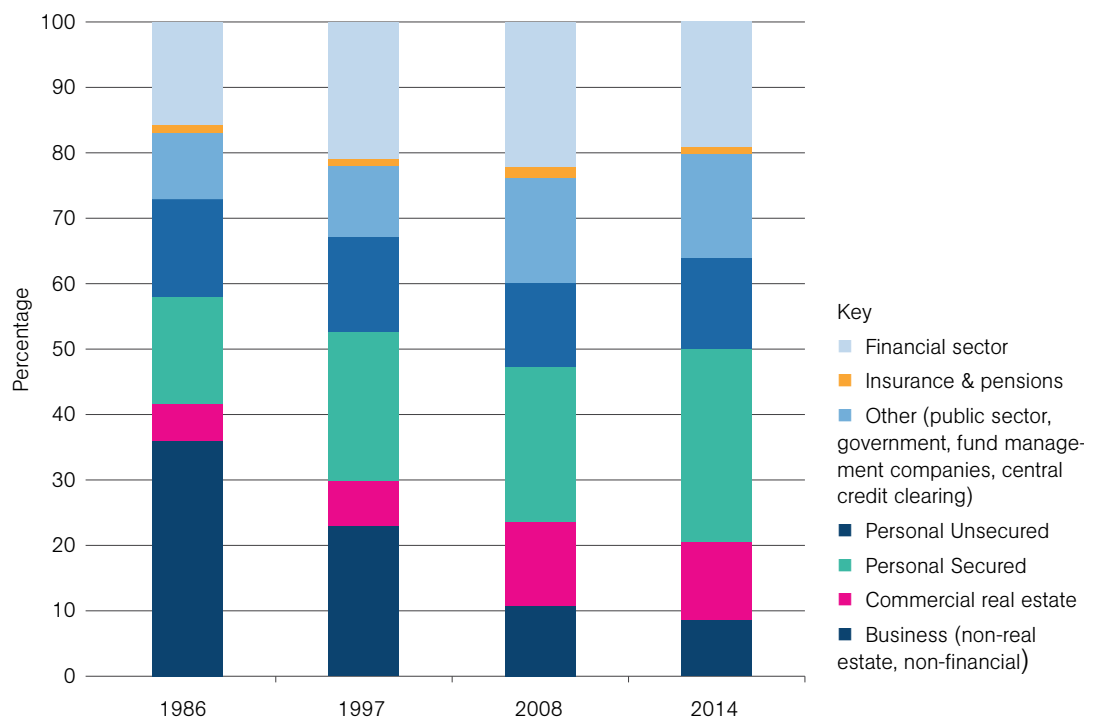
### Banking as a utility: serving the economy?

We have seen that the claims made for the importance of the UK's international banking business to the economy are overblown. In fact, far from being a sign of over-regulation, trends such as falling employment in part reflect banks' prioritisation of their international trading business over their more jobs-rich (and less footloose) UK high-street operations. But how do these banks perform when it comes to their core function of connecting lenders and borrowers and providing finance for the real economy?

The UK's banks serve the domestic economy badly, with only a small proportion of their balance sheets supporting non-financial businesses. Instead, they have increased consumer and mortgage lending since the crisis, helping to fuel an unproductive and unsustainable housing boom in London and the South East.

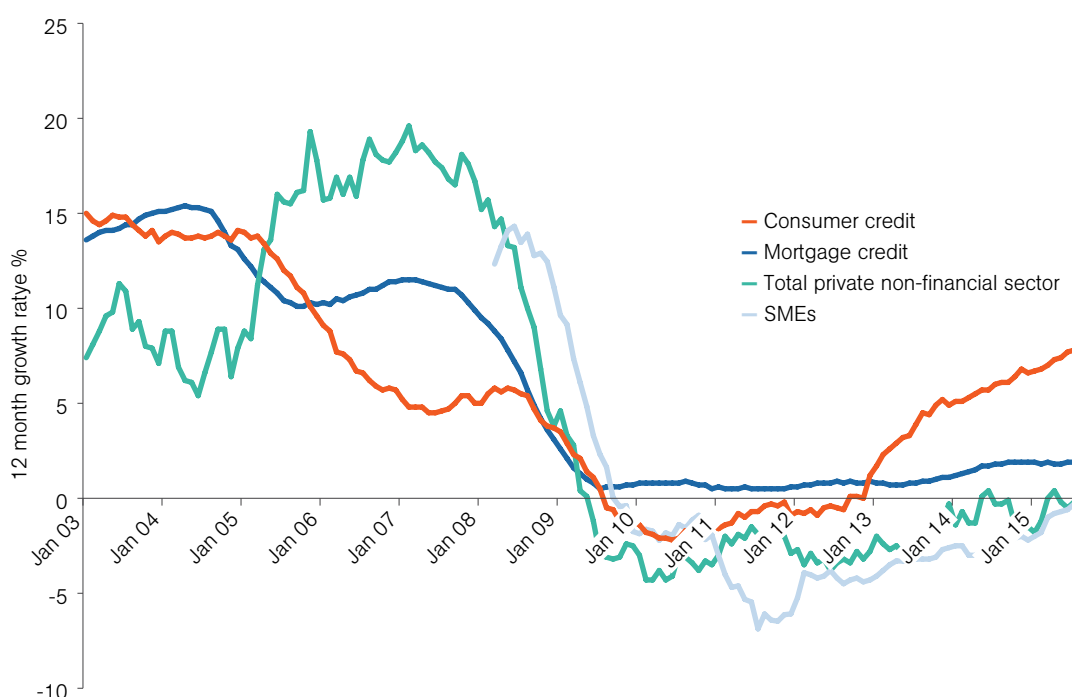
As Figure 7 shows, the share of UK bank lending going to non-financial businesses (dark blue colour) has been falling since the mid-1980s and is now less than 10%. Meanwhile, mortgage lending and lending to other financial institutions represents an increasingly large proportion of bank balance sheets.

Figure 7. UK domestic banks – composition of net lending by industrial sector



As NEF and others have argued elsewhere,<sup>51,52</sup> the apparent return to growth of the UK economy in the last few years is supported largely by household borrowing for consumption and mortgage lending (orange line in Figure 8) – neither of which appears sustainable given the already very high levels of household debt to disposable income in the UK.<sup>53</sup> Moreover, the recovery is heavily reliant on a house price boom in London and the South East. The UK domestic banking sector is providing the fuel for this price boom.<sup>54</sup>

Figure 8. UK bank lending by sector (12-month growth rate), 2003–2015



Source: Bank of England Interactive database, codes LPMB4TC, LPMVTYI, LPMVWNU, RPMZ8YT

As can be seen in Figure 8, lending to businesses generally and SMEs in particular has only just got into positive growth territory, seven years after the financial crisis, and remains well below historical averages. In other countries, including the United States, lending to firms recovered much more quickly or did not plummet at all.<sup>55</sup> This is despite a number of different subsidies offered to banks to subsidise SME lending, including Project Merlin and the Funding for Lending Scheme. Banks' SME lending is also highly regionally unbalanced, with around a third going to London and the South East (compared to just 3% to the North East and 5% to Wales).<sup>56</sup>

The key point here is that the unique features of the UK banking system which mean it fails to adequately support the real economy are the same ones which make it fragile and prone to instability. Our dependence on a small number of large, highly centralised universal banks both concentrates risk and means we lack the localised 'relationship banking' which in other countries underpins small business lending and regional development.<sup>57</sup> The shift in banks' business models – from a primary focus on taking in customer deposits and making real economy loans to a reliance on borrowing from



other banks and originating and trading securitised assets in the international capital markets – both generates systemic risks and erodes their core function of supporting the real economy. Empirical evidence from across many countries strongly suggests that this shift was a key reason for the financial crisis of 2008.<sup>58,59</sup> The imperatives of short-term shareholder value both incentivise excessive risk-taking and mean that lending to SMEs – involving high transaction costs for relatively small loans – is simply not profitable enough for big banks to focus on.<sup>60</sup> Addressing these structural flaws would yield a far greater economic prize than we could hope to achieve by a renewed focus on propping up the status quo.

Overall, as we summarise in Table 2, many of the BBA's claims that the UK's international banking model is an asset seem to be impaired, and they neglect to mention the liabilities it brings – most damning of all the cost of the last crisis and the very likely cost of the next one.

Table 2. On balance...

Assets	Liabilities
<p><b>405,000 jobs</b>  <i>Impairments:</i> banks have generally been reducing employment since 2001, especially in domestic retail banking, regardless of regulation, and mainly through automation and offshoring.</p>	<p>Economy wide employment since the bank crisis is precarious, regionally divided, badly paid, with considerable underemployment and less good jobs</p>
<p><b>5% of GVA</b>  <i>Impairments:</i> bank's contribution is falling, overstated, masks weaknesses in our economy and says nothing about our welfare</p>	<p>Output loss after the banking crisis is estimated between £1.8 and £7.4 trillion in 2010 – more recent research suggests it is more likely to be higher than lower</p>
<p><b>£31.3 billion total tax contribution.</b>  <i>Impairments:</i> total has fallen since 2008, less than half actually borne by banks; employees bear large share</p>	<p>Direct cost of the bank bailout estimated at £289 billion  Interest costs on money borrowed for bank bail-out estimated to be £5 billion/year (more than corporation tax of banks + bank levy in 2014)</p>
<p><b>Support for the domestic economy</b>  <i>Impairments:</i>  A low and shrinking share of lending goes to non-financial businesses, a growing share to mortgages</p>	<p>Business model of big four banks prevents alternative models emerging and rips off customers</p>

### 3. Threats to leave: why policymakers should not give in to bank blackmail

Banks continue to threaten to move elsewhere if regulation is designed against their interests. HSBC's recent threat to quit the UK and relocate its headquarters abroad is only the most recent example of such tactics. In this section we show why such threats can and should be faced down.

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All of these factors come together when we try to assess banks' threats to move businesses to other countries unless regulation is made as they wish it. The BBA makes this threat quite explicit. Commenting on its recent report, Chief Executive Anthony Brown said: 'Many international banks have been moving jobs overseas or deciding not to invest in the UK ... Wholesale banking is an internationally mobile industry and there is a real risk this decline could accelerate.'<sup>61</sup>

HSBC in particular has been very publicly and deliberately deploying this threat during a prolonged ten-month 'review' of its headquarters. At the time of writing, it had just confirmed its decision to remain in the UK, having secured a string of concessions on tax and regulation. The bank's lobbying was widely credited with bringing about changes to the bank levy which allowed it (and Standard Chartered) to reduce its tax bill,<sup>63</sup> and it has been among those lobbying vocally for the ring-fencing regime to be scrapped or watered down.<sup>64,65</sup>

But beyond HSBC, there are more general reasons to think that threats to leave are not particularly credible - and that, if they were carried out, the consequences might not be as disastrous as the bank lobby claims.

#### Would big banks really leave the UK?

The most plausible scenario is that banks could split their international investment banking business from the domestic banking business and move it elsewhere. But our analysis suggests that this is unlikely.

First, if banks moved their banking business elsewhere they would give up the implicit backing of the UK government that they obtain largely through being too big, and being connected to UK domestic banking. We have seen that even with bank borrowing costs very low, this implicit backing is worth around £5 billion per year to them, and more if bank borrowing costs start to rise. They would need to relocate to an economy large enough to offer similar support - and what is more, to one which did not threaten even tighter state control than the UK in exchange for this support.

Second, front-office trading and client relation jobs in wholesale banking are much 'stickier' than banks suggest when threatening to relocate to other financial centres. London offers many advantages which bankers themselves admit are difficult to replicate elsewhere: not just a global language and a time-zone between the USA and Asia, but also an ecosystem that supports the city's international banking, from law firms to hedge funds to business schools.<sup>66</sup> London remains the largest trading centre for the euro despite attempts to establish international financial centres inside the eurozone – 'traders in the City of London financial centre now buy and sell more than twice as many euros as the whole 19-member euro zone'.<sup>67</sup>

### **If banks did leave, how much would it hurt the UK?**

Leaving this aside and assuming that banks' threats to leave were acted upon, what would the net economic impact really be? As we have seen, barely a quarter of UK banking jobs are in wholesale banking (around 120,000), and not all of these jobs would move given a relocation of headquarters. At the same time, this number is falling regardless of any decision to relocate, thanks to technology and the cost of London.

Looking more generally at the contribution of international banking to the UK economy, be it tax, GDP, or jobs, the net impact seems likely to be negative once we include the ongoing impacts of financial crises and implicit or explicit taxpayer support. International wholesale banking brings the very real possibility of infection from global financial crisis, the cost of which far outweighs the meagre benefits.

What's more, it seems very likely that the UK banks' obsession with international business is part of the reason why UK banking serves the rest of the economy so poorly. What the UK economy needs is not more wholesale banking, but more 'boring banking' – not more of banking as a sector in its own right, but more of banking as a utility. Promoting a more diverse range of stakeholder banks with a regional and local focus could dramatically transform the job that UK banking does for the economy and society.<sup>68</sup>

## Conclusion

In a turbulent global economic climate, with commentators increasingly talking about the risk of another crash, there is no room for complacency about the resilience of the UK's financial system.

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Post-crisis reforms have largely failed to address the structural problems in our banking system, and there remains an urgent need for more serious action. It is therefore deeply concerning that the policy environment seems to be moving in precisely the opposite direction. With public attention no longer on the banks, tax and regulation are being quietly remoulded around the demands of bank lobbyists, backed up by the threat to move their headquarters out of London. This amounts to a huge gamble with the future of the UK economy, as well as a lack of ambition to build a banking sector that genuinely serves society.

We recommend that:

- **The Bank of England should significantly strengthen the lightweight ring-fencing regime.** An urgent clamp down is needed on ring-fenced banks' economic links with the rest of their banking group. If banks continue seeking to water down and 'game' the regulation, full structural separation between retail and investment banking must be reconsidered.
- **The Financial Policy Committee should consider more active credit guidance policies.** More active intervention could stimulate real economy lending and dampen down both mortgage lending and lending to other financial corporations.
- **The Treasury should urgently review options for addressing the lack of diversity in the UK banking system,** and for promoting a more vibrant local stakeholder banking sector. This should include examination of the full range of options for the public's majority stake in the Royal Bank of Scotland (RBS).

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**Written by:** Christine Berry, Duncan Lindo,  
and Joshua Ryan-Collins  
**Proofed by:** Mary Murphy  
**Designed by:** danfarleydesign.co.uk  
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**New Economics Foundation**

[www.neweconomics.org](http://www.neweconomics.org)  
[info@neweconomics.org](mailto:info@neweconomics.org)  
+44 (0)20 7820 6300  
@NEF



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