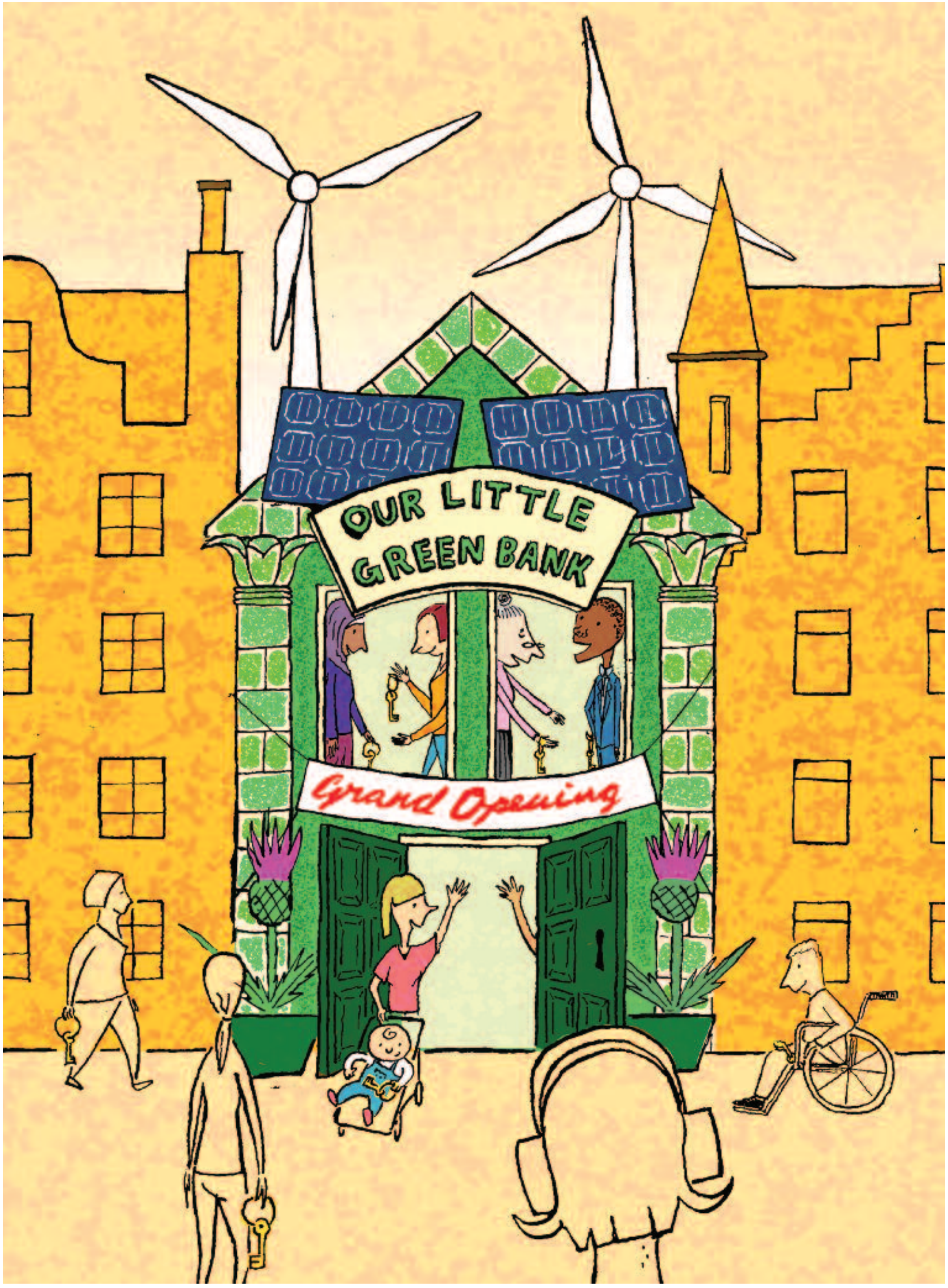
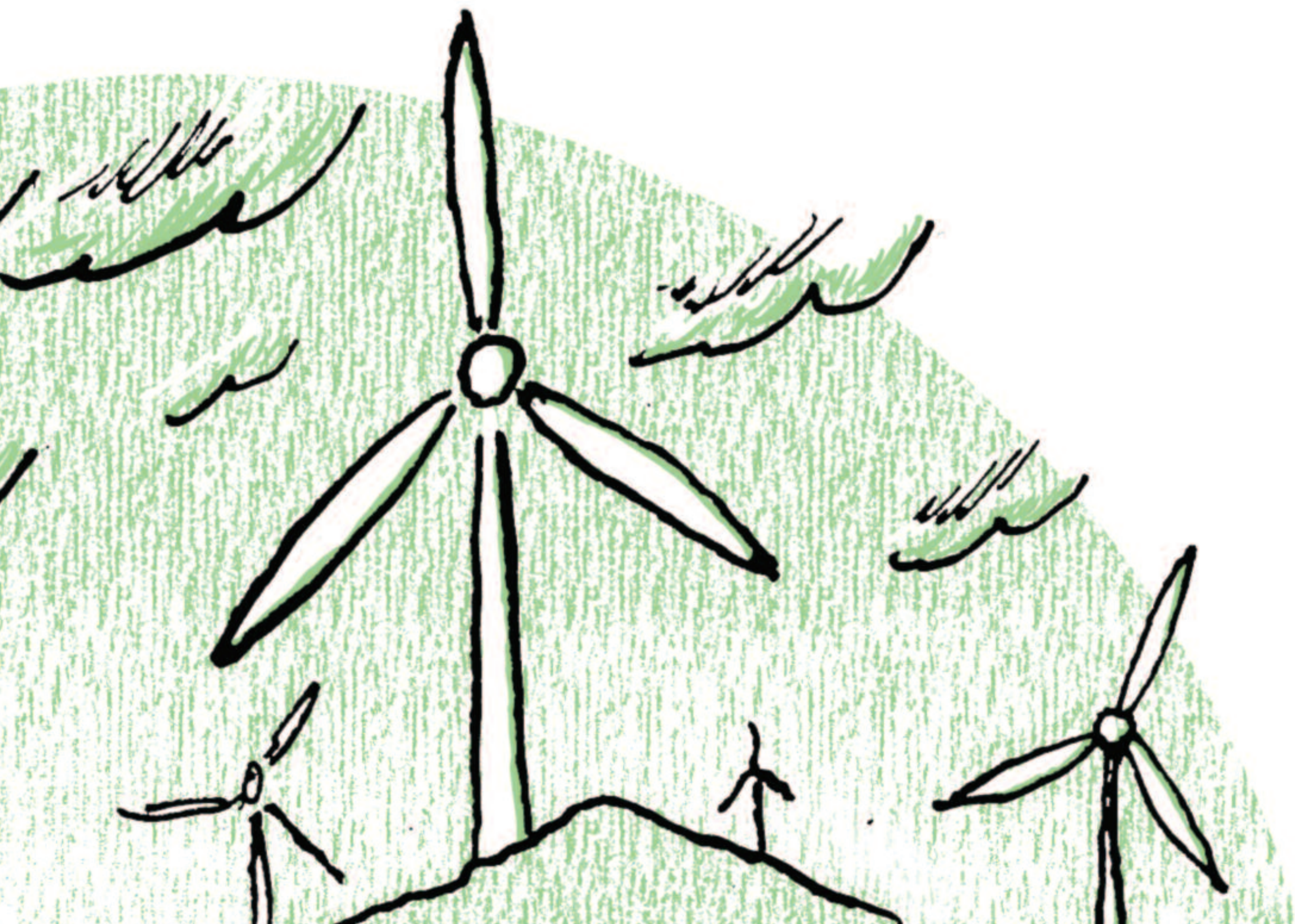
Smaller, Greener Banking

Banking for Sustainability in a New Scotland



A Discussion Paper

by Ray Perman
and Friends of the Earth Scotland



Executive Summary

Despite the reforms brought in after the financial crash, we still have a banking system which does not adequately meet the needs of society – and in particular does not provide support for a sustainable[a] future.

This paper does not try to be a blueprint for a root and branch reform of the UK banking system – desirable as that may be. It is intended to stimulate debate on how banking in Scotland could and should try to be better and with this in mind makes the following recommendations:

Banking Giants

1 Whatever the outcome of the referendum on independence the Scottish Government should present as strong a case as possible for breaking up the two dominant banks to form a more diversified and competitive market in Scotland.

2 Banks should be encouraged to devolve more decision-making to local managers and to adopt governance models which promote local accountability.

Finance for Sustainability

3 The Scottish Government should consider contributing to the Green Investment Bank to counter the fall in investment in renewables, with a particular focus on increasing finance for community renewable projects and the development of wind, tidal and wave technology.

4 To respond to concerns about the "carbon bubble" the Scottish Government should re-examine its policy on the extraction of fossil fuels including North Sea oil and gas.

5 All banks and investment management companies operating in Scotland should be required to publish the carbon intensity of their loanbooks and equity portfolios to enable them to reduce the carbon intensity of their investments in line with existing legislation to cut carbon emissions.

Small, Accountable Banks

6 In an independent Scotland the Scottish Government should influence banking competition to encourage new entrants to create a more diverse banking sector which takes more notice of community needs and builds environmental sustainability into its lending criteria.

7 If there is a No vote in the referendum in September 2014 the Scottish Government should lobby in London and Brussels for regulatory frameworks which favour non-traditional business models including credit unions, regional, local, cooperative and municipal banks.

a For clarity, "sustainability" is used in this paper only to mean environmental sustainability. "Stability" is used in a financial context.

Introduction

Safer, but sustainable?

Following the banking crash of 2007– 8, when governments in many countries were forced to provide huge amounts of capital and liquidity to prevent a collapse of the banking system, there have been many attempts to make banks financially stable. In the UK we have had the Vickers Commission, which looked at the structure of banks, and the Parliamentary Commission on Banking Standards, which looked more widely, particularly at the culture of banking.

£45.8 bn bail-out

UK Government cash bail-out of RBS.[1]

£7.4 trillion worse off

Cost of the credit crunch in lost output according to the Bank of England.[2]

Those inquiries resulted in the Banking Reform Act of 2013 [3] which sought to make banks safer by separating personal and small business banking from financial trading, establishing new regulatory bodies and introducing new standards of conduct and increased measures of depositor protection. Internationally, the Basel Committee, an international group of supervisory bodies, introduced Basel III, a new standard requiring banks to retain higher levels of capital as a safeguard against loss. This replaced the Basel I and Basel II accords, which had been hopelessly inadequate in curbing the behaviour which led to the banking disaster.

None of those reforms, either domestically or internationally, has been either quick or straightforward. In the UK there has been disagreement between the banks, the Confederation of British Industry and the Government over how the "ring fence" suggested by Vickers and the Parliamentary Commission should be applied.[4] Basel III was to have been implemented by 2015, but following rethinking by the regulators and resistance by the banks the deadline has now been extended to 2018.

Some commentators are by no means certain that five years after the crash, despite the efforts of regulators, we have yet achieved financial stability.[5] At the root of this uncertainty is a failure of government policy to decide the role banks should play, and therefore what sort of institutions they should be. They have been allowed to be driven by profit maximisation (under the guise of 'shareholder value'), so that we have ended up with a banking system dominated by a small number of giant banks, which still – even after the crash, the rescues and the reforms – pose a threat to the economy of the entire UK.

In a genuinely free market these institutions would not be able to survive. They are only able to do so because of the implicit guarantee given by the state by virtue of the fact that they are "too big to fail" – that if they were allowed to collapse the livelihoods of millions of ordinary people would be wrecked in the process. Yet what do we receive in return for this guarantee? A banking system which does not offer genuine choice to the consumer, which has been frequently fined by regulators for defrauding its customers, which has acted illegally in manipulating interest rate and foreign exchange markets and has even been accused of rigging the price of gold. It has failed to support small businesses through the recovery and indulges in practises which Lord Turner, former chairman of the Financial Services Authority, described as "socially useless."

Government has responded, not by trying to reform the banking system, but by creating new institutions with public money to do the jobs which the commercial banks should be doing – the UK Business Bank and the Scottish Investment Bank to invest in businesses, the Green Investment Bank to invest in renewables. These are not an answer to the problem, they are a way of avoiding it.

What kind of sustainability?

In April 2014 the Intergovernmental Panel on Climate Change (IPCC) issued its fifth report on the mitigation of climate change, urging speedy action to switch from burning fossil fuels to renewable sources of energy.

Official efforts have used the term "sustainability" to refer to the internal financial health of banks. They have been silent on the question of environmental sustainability, despite the fact that banks, through their own operations and their lending policies, can have a big impact, either positively or negatively.

42% by 2020

Reduction in CO_2 emissions required by Scottish Law.[6]

Friends of the Earth Scotland and others have been campaigning since 2007 for banks to be required to adopt a true definition of sustainability by integrating social and environmental sustainability criteria in their credit risk assessment system.[7, 8] But as yet this has found little support among policymakers. In fact there is evidence that the tightening of capital controls on banks is inhibiting the growth of green technologies.[9]

Yet there are moves by the International Financial Reporting Council and others towards bringing the financial sector into line with advances in environmental and human rights sustainability reporting and rating.[10] For many years banks have published corporate social responsibility reports, detailing their own environmental impacts, but have been reluctant to disclose the effects of their lending practices – a much more important factor. The World Development Movement calculated that RBS was responsible for 735,000 tonnes of carbon emissions[b] from its own activities in 2012, yet its £43 billion in energy loans resulted in 1,200 times as many emissions.[11]

Banks can change their behaviour. Some are already starting to build sustainable business principles into their business models, but the practice is not yet mainstream. Such measures as do exist (see for example RBS's advocacy of the Green Bond Principles of transparency in providing information on the environmental impact of projects)[12] have been adopted in response to pressure from consumers and civil society, rather than regulation. In this instance Government and regulators have lagged behind public opinion and corporate behaviour.

There is evidence that campaigning works. In 2005 HSBC, one of the largest global banks and one with extensive activities in the Global South, particularly in Asia and South America, changed its policy in relation to the financing of projects involving dam construction and freshwater generally. Although many of HSBC's lending practices have not changed, a significant victory was won by environmental groups to end project finance support for dams and involve the bank in a worldwide programme of freshwater improvements.[13] RBS has also introduced Environmental, Social and Ethical screening (ESE) which it applies to proposals affecting six industry sectors, including *Power Generation, Oil and Gas* (including oil sands, deep sea oil exploration and Arctic drilling) and *Mining and Metals*, including mountain-top removal mining.[14]

A by-product of the PPI insurance scandal, in which banks were exposed as acting cynically and dishonestly towards their customers, had been to renew the pressure on banks to demonstrate that they now act 'ethically,' not only towards their customers, but also towards the environment. Some now not only brandish their own environmental credentials by, for example, signing up to the Carbon Disclosure project, which Lloyds and RBS have both done, but offer to help their customers clean up their acts too[15]. We may be sceptical about the real motives for doing this, but if it influences businesses to be more aware of their own impact on the planet, then it is a good thing.

b Measured in tonnes of CO_2 equivalent.

The concept of an 'ethical bank' has taken a knock with the widely publicised problems of the Co-operative Bank, where governance and management did not live up to the bank's high aspirations. Nevertheless, there are long established banks which have always tried to act ethically. One example is Triodos[16], based in the Netherlands, but also active in the UK. It has subordinated the pursuit of growth and profit to the maintenance of the social and ethical principles on which it was founded.

Less profit and higher risk?

Should we encourage sustainable banking, or by doing so are we merely encouraging banks to incur unnecessary additional costs? Will we be giving them further excuses not to lend to viable businesses at a time when they are already being criticised for not increasing their lending quickly enough?

This was once economic orthodoxy – that by implementing responsible environmental measures or by paying their employees a living wage, companies were putting themselves at a competitive disadvantage and risked being put out of business. There is now a respectable and growing body of evidence to suggest that the reverse is the case: although there may be short-term costs, over the long term sustainable companies do better than unsustainable companies.[17]

Banks have always sought to assess the financial stability of the companies and individuals to whom they lend, but the costs of ignoring wider sustainability can be substantial. Companies face clean-up costs, legal actions to recover the costs of environmental damage, consumer boycotts, and reputational damage for permitting low wages or unsafe conditions in their factories or those of their suppliers.

It makes sense for banks to take a broader definition of sustainability into account when assessing their loan criteria and an increasing number of banks are doing this, encouraged by the Global Alliance for Banking Values (although so far they are mainly smaller, community based institutions, such as Triodos).[18]

Action by consumers or civil society can have an effect, but investment institutions, which hold large blocks of shares in major banks, are in a better position to force immediate change. They are often as – or more – conservative in their own attitudes than the banks, but some are starting to take a lead. "Often companies do not need to make a choice between ethical goals or higher financial returns – that's the great attraction," says Craig Mackenzie, Head of Sustainability at Scottish Widows Investment Partnership, one of the largest asset managers in Scotland. "There is frequently a clear business case. In the face of rising energy costs, reducing emissions means making more money."[19]

So what can be done, and particularly what can be done in Scotland? How can banking in Scotland be different and better serve the needs of people and provide support for a sustainable future?

7 times greater

RBS's total assets are worth 7 times the national income (GDP) of Scotland

RBS balance sheet 2013 = £1,027 bn[20]

Scottish GDP 2013 = £131 bn[21]

Banking Giants

Scottish banking: a degraded landscape

Banking in Scotland has changed considerably as a result of the banking crash. The country's two largest banks, RBS and HBOS (formed by the merger of Bank of Scotland and Halifax) both became insolvent and had to be rescued. RBS is now 81% owned by the UK Government and HBOS was acquired by Lloyds, which itself had to be rescued by the Government. Depositors were protected, but tens of thousands of workers lost their jobs and shareholders – including millions of ordinary people and employee-shareholders – lost most of their investment.

To survive, both banks have had to write off losses on an unprecedented scale and shrink their balance sheets. The most marked effect in Scotland, however, has been the loss of top decision-making. Although both banks are still technically headquartered in Scotland, in reality top decision-making has moved to London.

These were not the only casualties. Although much smaller, the collapse of the Dunfermline Building Society had a dramatic effect on its local community. It was rescued by the Nationwide Building Society.

81% Ours

RBS is 81% owned by the UK Government [22]

As a condition of the Government rescues, the European Commission forced Lloyds to spin-off 600 branches into a new reborn TSB, although despite having a third of its business north of the border and the Trustee Savings Bank movement having its historic roots here, the bank is headquartered in London. RBS is also having to spin off 300 branches (to be renamed Williams & Glyns), but it also will be headquartered in England. Clydesdale Bank, owned by the National Australia Group, has also suffered a steady loss of autonomy.

From once being one of the largest banking centres in Europe, Scotland is now a branch banking economy. The largest institution genuinely run from here is the Airdrie Savings Bank, a venerable and admirable institution, but a small operation which knows its limits both in geography and balance sheet terms.

Analysis: Scotland as part of the UK

In May 2013 the Scottish Government published its banking strategy in a document called *Sustainable, Responsible Banking* [23], which showed that although employment had fallen by 16% since 2008, the banking sector was still one of Scotland's major employers, providing 43,500 jobs. It called on the banks to make efforts to restore trust between banks and their customers, improve security and resilience, encourage community banking and credit unions and extend banking services to the financially-excluded. The strategy called for more diversity and customer choice in banking, while also noting that two banks, RBS and Lloyds (which owns Bank of Scotland) have 70% of the personal and SME markets.

On the subject of environmental sustainability, the document said:

> *"The people of Scotland want to have confidence that the banks have their interests – and that of their money – at the centre of everything they do. They also want to know that banks as organisations operate ethically and responsibly in the world, taking into account environmental and social considerations, as well as the impact they have on the global economy."*

The Scottish Government's Council of Economic Advisers has been more explicit:

> *"The fragile economic recovery and economic outlook may increase the reluctance of some to invest in more responsible behaviours. Whilst some firms may view any changes as an irrecoverable cost, many firms have been found to benefit from integrating sustainability into their core business objectives.*
>
> *"There is a significant opportunity for Scottish firms to reduce costs and gain advantage by improving their resource efficiency, especially as significant recent rises in global commodity prices have acted to constrain growth. DEFRA estimate that UK businesses could save around £23 billion per year from simple resource efficiency measures and the Scottish Government should continue to encourage increased energy and resource efficiency across the public, private and third sectors."* [24]

The Scottish Government has, itself, directly tried to improve the diversity in the banking sector by launching the Scottish Investment Bank, which lends to medium sized businesses through the Scottish Loan Fund. It has been examining the case for more broadly based debt product and for a Scottish Business Development Bank.

However, the powers currently devolved to Scotland do not include either financial services regulation nor competition policy. The Scottish Government therefore currently has little ability to influence the shape and behaviour of the banking market.

If Scotland votes No in the referendum in September this situation will not change. Scotland is already guaranteed further powers over tax and the three unionist parties are promising even more, but no party has yet suggested devolving either financial regulation or competition policy. The Scottish Government therefore will have no direct ability to change the shape of the banking industry (by, for example, breaking up one of the banks to force more competition) and influence over behaviour will have to be by argument and exhortation rather than regulation.

In this situation, continued consumer and civil society pressure on banks to behave responsibly will be essential.

Analysis: Banking in an independent Scotland

Should Scotland vote Yes the situation will become more complicated. Post-independence it is likely that there would be no large Scottish-owned and registered banks. We could see an influx of foreign banks keen to take advantage of the new opportunities. This happened in the 1970s, when US banks set up offices in Scotland to look for participation in oil financing. This time it would be to take advantage of the government debt market the Scottish Government would have to create.

Most people and businesses would bank with branches of banks owned outside the country. The retention of the Royal Bank of Scotland and Bank of Scotland names and the inertia of most bank customers would still give these banks an advantage, but with encouragement from the regulator new entrants could make the market more diverse and competitive.

The Scottish Government's preferred monetary arrangement is a currency union with the remainder of the UK. In this case, the Bank of England would remain the lender of last resort to banks headquartered in Scotland and there would be consistent prudential regulation (for example, enforcing minimum capital requirements to make banks safer) across the Sterling area to ensure financial stability.

Should Scotland not be able to negotiate a currency union and have to choose a different course (using Sterling outside a currency union, adopting a new currency or joining the Euro) it is likely that the two largest banks – RBS and Lloyds – would move their headquarters and registered office from Scotland to the UK. They may have to do this anyway to comply with European regulations, which oblige banks to be registered and regulated in the same country as the majority of their customers. They could also face a downgrade in their credit ratings and an increase in their funding costs were they to remain north of the border. There would be some further loss of head office jobs, but the real implication would not be felt for some time. Currently Lloyds and RBS are making losses and even when they return to profitability they will be able to offset these for tax purposes against the losses they incurred in the financial crash. However, if they do return to profitability any Corporation Tax they pay would accrue to the Government in the rest of the UK, not to Scotland.

Breaking up the banks

Fifteen years ago Sir Don Cruickshank's inquiry highlighted the concentrated UK market for personal and small business banking, where the four largest banks had between them 68% market share. Since then the situation has hardly changed. The five largest banks – Lloyds, Barclays, RBS, HSBC and Santander – have between them 73% of the UK market.[25]

In Scotland, as the Scottish Government pointed out in its banking strategy document, the position is much worse. Just two banks – Lloyds (owner of Bank of Scotland) and RBS – hold 70% of the small business banking and personal banking markets. This duopoly was identified 15 years ago by Cruickshank, but only weak remedies were imposed. This concentration is anti-competitive and works against the interest of consumers and the economy. It should be rectified by forcing the banks to sell or spin-off branches and head office operations to form new challenger banks.

70% control

Together Bank of Scotland and RBS control 70% of the small business banking market in Scotland.

The Competition and Markets Authority is to launch a full inquiry into UK retail banking. The Scottish Government should use this opportunity to present as strong a case as possible for breaking up the two dominant banks to form a more diversified and competitive market in Scotland.

In the short term the practical effect may be limited. Since the RBS takeover of NatWest 15 years ago and the Lloyds takeover of Bank of Scotland as part of HBOS, both banks have become highly integrated across the UK. It would be time consuming to separate IT systems and involve immediate costs. Any new banks created would probably have to share systems for several years, throwing doubt on their genuine independence. This is the case with TSB, which is being spun out of Lloyds at the insistence of the European Commission. Although nominally a separate institution, its customers' accounts will be run from Lloyds computers for years to come. Careful scrutiny by the competition authorities is going to be necessary to ensure genuine competition between TSB and its former parent and would be needed to ensure that any new banks formed from branches of Lloyds or RBS did become genuinely independent and competitive within a specified period.

Should there be a Yes vote in the referendum, an independent Scotland would have control over competition policy and could launch its own inquiry. An independent Scottish Government would not have the power to force a break-up of the two banks on a UK scale, but might be able enforce the divestment of some Scottish branches or operations to reduce their market share and encourage new entrants. Some commentators have argued that after independence the Scottish Government would inherit a "population share" of the UK Government's holding in RBS and that it could use this lever to force a divestment of the RBS branches and operations in Scotland. It is debatable whether a stake of 6 – 7% would be enough to secure a break-up.

The UK Government has already started selling down its holding in Lloyds, so it is likely that on the date of independence the proportion of shares which would transfer to the Scottish Government would be too small to exert much influence. The large market share held by Bank of Scotland would, therefore, also be left intact.

Recreating local accountability

Until the internal reorganisations of RBS and Bank of Scotland in the 1980-90s, both banks operated much more decentralised models of governance and decision-making. Regional boards, comprising senior executives from the region, plus non-executive directors drawn from local businesses, oversaw lending decisions and operations in the North, East and West of Scotland. Such boards (exclusively white, middle-aged, middle-class male and fraught with potential conflicts of interest) would not pass corporate governance codes today, but they did give a measure of local influence and accountability. They could be overruled by the main board of the bank, but in practice their recommendations based on local knowledge were often accepted.

In those days branch managers also had much more responsibility and flexibility in assessing credit worthiness of local business and individuals and making loans. Lending decisions could be made by the manager and this power gave him (rarely 'her') status in the local community. This power has largely been taken away from managers and lending decisions to individual customers and businesses automated through computerised 'credit scoring.' There is no local accountability and often the person in charge of a branch has little or no influence over a credit decision. This deskilling of banking has led to a decline in banking education, with few managers taking the exams of the Chartered Institute of Bankers in Scotland.

The feelings of customers that decisions which affect them are taken remotely without knowledge of their individual circumstances have helped to break down the trust between banks and customers which used to exist. To begin to try to rebuild this trust it is not necessary to go back to the business models of a previous generation, but thought should be given to ways in which new models of governance and accountability can be developed.

Changing behaviour

If an independent Scotland became a member of the European Union in its own right, it would be required to establish a financial conduct regulator, to set standards for the behaviour of banks. This would be the case whether or not Scotland entered into a currency union with the rest of the UK. This could offer a genuine opportunity to encourage and compel higher standards, perhaps more in line with recommendations of the UK Parliamentary Commission on Banking Standards[26], which provided a detailed blueprint for cleaning up the banking system. The Scottish Government has already shown itself willing to demand higher levels of probity than the rest of the UK with its Tax and Revenue Bill, which promised to clamp down on tax avoidance, rather than just tax abuse.

It is likely that a future Scottish Government would use any new powers to promote the ideas it explored in last year's banking strategy, such as fairness and transparency in dealings between banks and customers, higher professional standards, encouragement of community banks, an end to financial exclusion and so on.

Banking Giants: recommendations

1. Whatever the outcome of the referendum on independence the Scottish Government should present as strong a case as possible for breaking up the two dominant banks to form a more diversified and competitive market in Scotland.

2. Banks should be encouraged to devolve more decision-making to local managers and to adopt governance models which promote local accountability.

Finance for Sustainability

Financing the green economy

An independent Scottish Government would be likely to encourage banks to lend to renewable energy and waste reduction projects and *Scotland's Future*, the White Paper on independence, said that it would expect the Green Investment Bank, a UK Government institution, which finances large financial infrastructure projects, to remain headquartered in Scotland. This cannot be taken for granted and would have to be the subject of negotiation. Currently the bank is entirely financed by the UK Department of Business Innovation and Skills, which is unlikely to allow it to continue to invest in Scottish renewable projects without a matching contribution from the Scottish Government.

It would be highly desirable for this to happen. The Green Investment Bank was established to counter the fall in investment in renewables felt across Europe in recent years. In its two-year life the bank has committed £1.3 billion of its own capital as well as bringing £4.8 billion from co-investors. Even so, there was a fall in investment in the UK of 11% – but without its intervention the fall would have been 30%. The bank is also attempting to take a leadership role in stimulating more investment in renewable technologies by raising a fund to bring in a wider range of investors. It has also received state aid clearance from the European Commission to invest directly in community schemes.

The attitude of commercial banks to the financing of renewable energy projects can be gauged from the experience of wind energy projects. Before they lend, banks must satisfy themselves that the project can generate sufficient cash to repay the borrowing. Banks were initially reluctant to finance wind farm developments – particularly those promoted by community groups – because the technology was unfamiliar, the markets not certain and the abilities of communities to manage schemes unproved.

An example of this is the pioneering wind development by the community on the island of Gigha. Commercial banks declined to lend the community the money to buy and install the initial three turbines in 2005 and loan finance was provided by Social Investment Scotland (SIS) – a body established by the Scottish Government to lend to community groups and charities.[c] Financially the project was far more successful than either the community or SIS had foreseen and by the time the second phase was commissioned, wind energy was accepted as a viable financial risk and communities across the country had demonstrated that they were able to successfully manage projects. Gigha had competing offers from commercial banks and the community trust was able to finance the development more cheaply than they could have done using Government money.

However, newer technologies, such as wave and tidal power, are still unproved commercially. They cannot yet generate reliable revenue streams and so could not repay borrowings. Banks will therefore not finance them and they require patient development capital, either from commercial energy companies, from Government or a partnership of the two.

Commercial venture capital and private equity companies have been reluctant to invest in new, unproven technologies and if the Scottish Government is serious in wanting to make Scotland a European leader in tidal and wave technologies it is going to have invest substantial sums in long-term research and development.

Fossil fuels

Should Scotland vote Yes the situation will become more complicated. The Scottish Government has taken a very strong line on reducing emissions and combating climate change. The targets it has set for Scotland are some of the most challenging in the world. It has failed to meet them in the last three years, but has taken a series of measures, including setting up a Cabinet sub-committee on Climate Change to try to get back on track. However there is a fundamental contradiction between this and its enthusiastic support for the North Sea oil and gas industry.

c The Author, Ray Perman, was chair of SIS from 2001 – 9.

For the foreseeable future any investment in renewables in Scotland will be dwarfed by heavy spending on fossil fuel extraction, particularly offshore oil and gas. The White Paper makes clear that an independent Scottish Government would support and incentivise production of North Sea oil and gas, the revenues from which will contribute to Scottish public income. Therefore it is very unlikely to regulate to deter or inhibit banks from lending to oil and gas companies and would face hostility from the oil and gas industry as well as the banking industry were it to seek to do so.

Indeed the Scottish Government's own Scottish Investment Bank has already made loans to companies in the Aberdeen-based oil services sector.

There is a marked difference in the attitude of the public and government to, say, fracking in Sussex or the extraction of oil from tar sands in Alberta[d], compared with the continued extraction of oil and gas from the North Sea. Our conventional fossil fuel industry does not excite controversy, yet the burning of all types of fossil fuels contributes to climate change.

In contrast to the UK Government, which strongly advocates the exploitation of onshore unconventional oil and gas, the White Paper is equivocal about the attitude of future Scottish Governments to onshore fossil fuel extraction through "fracking" or the exploitation of shale gas or coal-bed methane making it hard to predict what controls, if any, might be imposed on banks lending to such activities. Furthermore, the White Paper makes no mention of coal, despite the existence of open cast mining in Scotland.

Scotland's carbon bubble

The term 'Carbon Bubble' comes from a potentially devastating report, *Unburnable Carbon 2013* [29], by London-based non-governmental organisation Carbon Tracker and the Grantham Research Institute on Climate Change and the Environment at the London School of Economics. It has calculated the effect of burning all the fossil fuel reserves currently held by energy companies worldwide, state-owned and commercial, and matched this against the world's commitments to fight climate change by reducing emissions. Its conclusion is that if the world is to meet its targets these reserves cannot all be used – 60 - 80% of them must stay in the ground and become 'stranded assets.' The implications for governments and investors such as pensions funds are profound because the valuations of energy companies depend on the value of their fossil fuel reserves. If these reserves cannot be exploited, their valuations fall. These valuations also underpin lending by banks to fossil fuel extraction projects. In the words of Martin Wolf, the Financial Times's influential economics commentator, investors are making 'risky bets in the climate casino." [30]

£45 billion in fossil fuels

Scottish bank RBS invested £45 bn in fossil fuels between 2008 and 2012.[27]

18 times more CO_2 than Scotland

The carbon footprint of RBS' loans are 18 times the entire carbon footprint of Scotland.[28]

d The Alberta tar sands, which have a devastating impact on the global climate and are destroying the way of life for indigenous communities have been described as 'the most destructive project on earth' by the World Development Movement.

These concerns underline a critical contradiction in government policy. Public institutions and government departments are required by the Scottish Climate Change Act to reduce their carbon emissions towards an overall target reduction of 42% by 2020. However there is no obligation to make a similar cut in fossil fuel extraction – the source of most of these carbon emissions.

The response of the Scottish Government to the *Unburnable Carbon* report has been disappointing. Minister for Energy, Enterprise and Tourism Fergus Ewing told the Scottish Parliament that "no contradiction exists" between the policy of maximising oil and gas extraction and reducing emissions, "therefore suggesting that fossil fuels from the UK Continental Shelf will be extracted, exported and primarily burnt elsewhere," according to the Parliament's information service.[31] The White Paper, *Scotland's Future*, actually talks of a "prize" of four billion extra barrels of oil equivalent worth £200 billion over 20 years through increased recovery, with no indication of the effect this would have on emissions.

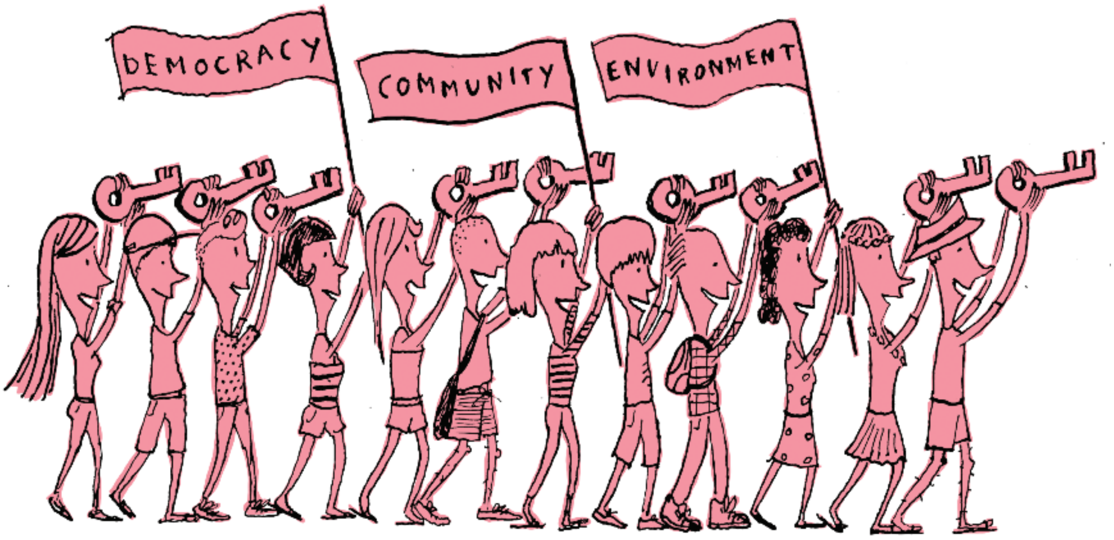
With the next UN Climate Change conference due in Paris in 2015 to consider new legally binding targets for emissions reductions, some investors and banks are already reconsidering their valuation models. The Scottish Government may have to do the same.

Finance for Sustainability: recommendations

3 The Scottish Government should consider contributing to the Green Investment Bank to counter the fall in investment in renewables, with a particular focus on increasing finance for community renewable projects and the development of wind, tidal and wave technology.

4 To respond to concerns about the "carbon bubble" the Scottish Government should re-examine its policy on the extraction of fossil fuels including North Sea oil and gas.

5 All banks and investment management companies operating in Scotland should be required to publish the carbon intensity of their loanbooks and equity portfolios to enable them to reduce the carbon intensity of their investments in line with existing legislation to cut carbon emissions.



Small, Accountable Banks

Alternative banking models

Globalisation, advances in banking and information technologies, the pursuit of perceived economies of scale (sometimes beyond the point where the benefits end) and increased prudential requirements have all hastened consolidation in banking markets. But Britain is unusual in the extent to which this trend has reduced banking variety and all but eliminated local and regional banks. Local savings banks and "post banks" still exist in many European markets, but vanished from British high streets decades ago. Scotland was the last part of the UK to retain a genuine regional banking market, but this ended in the crash of 2008. Smaller banks tend to be simpler, safer, closer to their customers and therefore more responsive to their needs. Many European small banks are also mutual or owned within their regions and therefore more accountable.

Germany, for example, despite suffering in the credit crunch, has preserved a much more diverse banking ecosystem than the UK with large national and international banks, regionally-owned Landesbanken and locally-owned Sparkassen. The regional and local banks are credited with financing the strong German 'mittelstand,' small and medium-sized companies – the type of businesses which have struggled to find loans in the UK.

So what can be done in Scotland? Despite the centralised system, some small foundations still survive on which we can build.

Municipal banks

At one time nearly every local authority in Britain operated its own bank. Five still exist in Scotland – North Lanarkshire, East Dunbartonshire, North Ayrshire, West Lothian and Clydebank – but their operations are small and the services they provide limited to personal savings accounts. The cash deposited by customers is invested in the local authority itself. Since councils routinely lend and borrow in the international money markets, they have good credit ratings and are safe custodians of their customers' funds.

A similar bank has been thriving in North Dakota for 90 years. Guaranteed by the State, which uses it for its own transactions, it also guarantees student loans, lends to businesses and issues State and municipal bonds. However, expanding municipal ownership of banks has proved difficult. The practical problems, particularly overcoming the inertia of customers to change their bank, are considerable. The North Dakota bank is the only one of its type in the US, despite attempts by other States and cities to follow its example.

Experience in the UK has also not always been easy with mixed experiences of municipal banking in the 21st century.

Early in 2014 Salford Council in Greater Manchester announced plans for a Bank of Salford, but so far it has not started trading.

In 2009 ‘Banking on Essex’ was set up as a municipal bank to lend to local small businesses which were struggling to raise commercial bank loans in the aftermath of the financial crash. It was a joint venture between the county council and Santander and backed with £100 million. But it closed two years later, having failed to attract enough customers. The set up cost was £386,000, but the bank lent only £535,000, not enough to generate income to meet its running costs.

'Cambridge and Counties Bank', launched in 2012 by the Cambridgeshire Local Government Pension Fund and Trinity Hall, a College of the University of Cambridge, appears to be doing much better. In its first year it claimed to have completed over 180 loans totaling £70 million to small and medium sized businesses (SMEs) and to have opened 1,500 SME deposit accounts. It also claims to be trading profitably. If this is true it would suggest that the real problem with ‘Banking on Essex’ was its management and marketing, rather than the principle of a local bank.

In theory there is no reason why the range of services offered by existing Scottish council banks should not be expanded to include personal and small business lending. They know their customers through council tax or business rates payment records. A change in the law might be required, or local authorities could partner with an existing “challenger” bank to use its banking licence. Other local authorities might be encouraged to follow suit. The idea is worth exploring further.

Credit unions

A promising challenge to the growth of payday lenders, if not the dominance of the big banks, is provided by credit unions. Membership of credit unions has grown strongly since the financial crash and new unions are being established. There are 113 credit unions in Scotland, with between them £200 million in deposits and £170 million in loans. They are tiny compared to the commercial banks, but their beneficial impact on the lives of people in the communities they serve can be substantial.

Credit unions are mutually-owned bodies set up under special legislation and draw their strength from the “common bond” which unites their members. This bond can be geographic (e.g. Fife, or Glasgow) or occupational (the NHS Credit Union). Borrowing from a credit union is expensive compared to a high street bank. The loan rate is currently capped at 2% a month (26.8% APR). Some credit unions charge less than this, but in response to fears about some unions not being able to survive, the Government has been consulting on raising the maximum rate to 3% a month. Even if the cap was increased, borrowing from a union would still be far cheaper than a payday loan, which can run into thousands of per cent. Government at UK and Scottish level have supported and encouraged the growth of credit unions, but there is a limit to their activities and recently the Prudential Regulation Authority had to rein in some unions which were pushing the boundaries of the services they are allowed to provide.

With the experience of the destruction of the building societies movement, there is understandable reluctance to allow credit unions to stray outside their safe limits. The 1986 Building Societies Act allowed building societies to demutualise and effectively turn themselves into banks, offering investment products and commercial loans alongside their traditional areas of expertise – personal deposits and mortgages. It is a sobering fact that no society which took this path still exists as an independent company – all either collapsed (some spectacularly, causing huge damage to their shareholders and the economy) or were absorbed into larger banks.

Credit unions are unlikely to become a real alternative to mainstream banks, but they do represent a viable and ethical alternative to payday lenders. Small credits can often make the difference that allows a family to turn around its life, or a local business to be started or take off. Credit unions should, and could, be encouraged further in that role.

Relentlessly local

A step up in size from credit unions, but still much smaller than the mainstream banks is the Airdrie Savings Bank. It is the last remaining mutually-owned savings bank in the UK, having refused over its 180 year life to join the Trustee Savings Bank movement or succumb to acquisition by one of the larger banks. Its strengths are its focus on the community it serves in North Lanarkshire and service to its customers, who are also its owners.

There is no reason why new community banks could not be started today, but the burden of regulation (aimed at larger institutions, but falling disproportionately on small and new would-be banks), plus the difficulty in meeting the “approved persons” regime for the bank’s top managers and directors, make this a daunting prospect for all but the most committed.

Banking on diversity

New regulatory requirements introduced in response to the financial crash have disadvantaged small, local banks compared to national and global institutions. There is much that can be done to encourage and support local banks and innovative financial models. This is not a uniquely Scottish or British problem and there are lessons to learn from abroad (see, for example, the submission by Australian regional banks to the Australian Government).[32]

Local banks are more responsive to the needs and aspirations of their local communities, they are easier to regulate and less costly to rescue should they get into trouble. But they are small and will struggle to survive in an environment where two banks have 70% of the market. Tackling that dominance is the key to a more sustainable banking system.

We cannot change the banking system by wishful thinking. If we want to see banking become sustainable for societies and our environment we need to sustain our own pressure on governments, regulators and the banks themselves to act responsibly.

Small, Accountable Banks: recommendations

6. In an independent Scotland the Scottish Government should influence banking competition to encourage new entrants to create a more diverse banking sector which takes more notice of community needs and builds environmental sustainability into its lending criteria.
7. If there is a No vote in the referendum in September 2014 the Scottish Government should lobby in London and Brussels for regulatory frameworks which favour non-traditional business models including credit unions, regional, local, cooperative and municipal banks.

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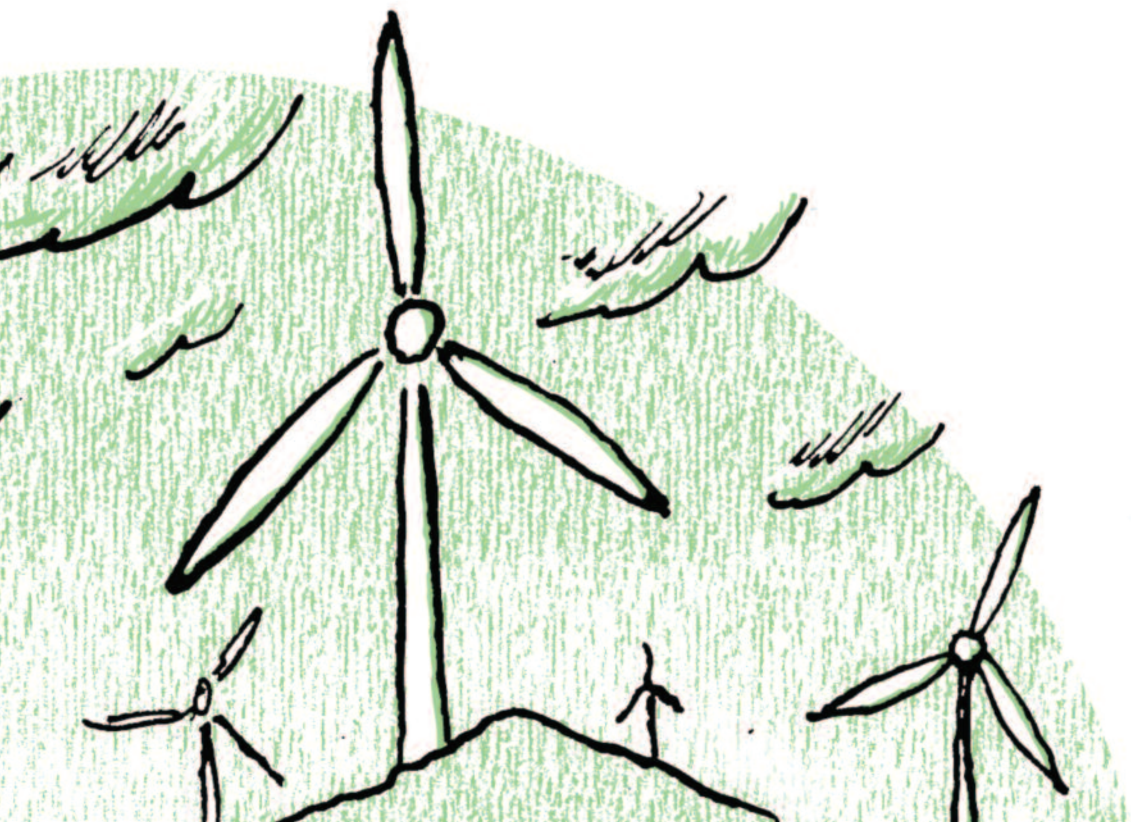

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