A UK Banking Disclosure Act

From theory to practice

Karl Dayson, Pål Vik, Dory Rand and Geoff Smith

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About Community Finance Solutions

Established in 1999 and located within the University of Salford, Community Finance Solutions (CFS) is an independent research and development unit specialising in financial and social inclusion, and community asset ownership. Founded in 1999 by Professor Karl Dayson and Dr Bob Paterson, CFS seeks to empower communities to solve local problems relating to land and financial exclusion. CFS has developed solutions for securing community ownership of land and models for the provision of loans to low-income, excluded households in more than a dozen communities across the UK. CFS has conducted research on a number of areas including: the operational and financial sustainability of the UK community finance sector; the social and economic impact of financial inclusion interventions; the nature and extent of financial exclusion in communities; the business case for investing in financial inclusion interventions; and the governance and self-regulation of the European microfinance sector.
www.communityfinance.salford.ac.uk

About Woodstock Institute

Woodstock Institute is a Chicago-based research, policy, and advocacy nonprofit that works locally, nationally, and internationally to promote community reinvestment and economic development in lower income and minority communities. The Institute's goals are to increase the assets of targeted families and communities, improve financial security for low-wealth households, and increase access to fairly priced and appropriate financial services and products in underserved markets. The Institute engages in applied research, policy analysis, technical assistance, public education, and programme design and evaluation to promote its goals. Its areas of expertise include community reinvestment and economic development policies and practices, the financial services and insurance industries, the impact of high-cost housing and consumer loan products, community development finance institutions (CDFIs), and the influence of financial conditions on family well-being. It works with community-based organisations, financial institutions, government regulatory agencies, foundations, the media, and others to promote its goals.
http://www.woodstockinst.org/

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We take full responsibility for any errors or omissions in the report.

Karl Dayson and Pål Vik
Community Finance Solutions, University of Salford

Abbreviations

ABCUL	Association of British Credit Unions Ltd
BBA	British Bankers' Association
BME	black and minority ethnic
CDFI	community development finance institution
CRA	Community Reinvestment Act
FCA	Financial Conduct Authority
FDIC	Federal Deposit Insurance Corporation
FFIEC	Federal Financial Institutions Examination Council
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSMA 2000	Financial Services Markets Act 2000
HMDA	Home Mortgage Disclosure Act
MLAR	Mortgage Lending and Administration Return
nef	New Economics Foundation
OCC	Office of the Comptroller of the Currency
OFT	Office of Fair Trading
OTS	Office of Thrift Supervision
PAT 3	Policy Action Team 3
PRA	Prudential Regulation Authority
RAL	refund anticipation loans
RAO 2001	(Regulated Activities) Order 2001
SME	small and medium sized enterprise
SOA	Super Output Area
SITF	Social Investment Task Force

Executive summary

This report analyses the risks and opportunities associated with the possible introduction of a UK Banking Disclosure Act. Banking disclosure involves disclosure to the public of data on lending and investment in geographic areas and to certain groups by individual institutions. Such disclosure is almost unique to the financial sector due to concerns about discrimination against certain communities and the impact this has on economic development in these communities. In the US, financial institutions have been required to disclose their lending and investment in deprived communities since the 1970s. In the UK, there have been numerous calls for disclosure since the late 1990s, but to date there has been relatively limited public debate concerning the merits of disclosure legislation. Suspecting that this may be due to a lack of consideration of the wider implications, this report carefully examines the risks and opportunities associated with introducing such legislation.

The definition of banking disclosure we have adopted for this report stresses that (a) the data must be available to the public, and (b) it must be disclosed by individual institutions. In the US, financial institutions have been required to disclose data on socio-economic, demographic and loan characteristics, and outcome of applications, at the level of the mortgage applicant under the 1975 Home Mortgage Disclosure Act (HMDA); and on lending to small businesses and to low- and moderate-income communities under the 1977 Community Reinvestment Act (CRA). Current banking disclosure in the UK is uneven, not standardised and not currently broken down to specific geographical areas. However, the British Bankers' Association (BBA) is due to disclose industry-wide figures on small business lending by postcode area, which will address the latter point.

The calls for disclosure vary considerably in nature and magnitude. Some call for individual banks to disclose lending in the most deprived communities, which they already do on an industry level. Others argue for much more comprehensive geographical and customer-level disclosure along the lines of that required in the US. Our analysis suggests that the case for UK banking disclosure legislation, based on the opportunities it would present, is only partially supported by the empirical evidence. UK banking disclosure along the lines of US disclosure would on its own not be sufficient to identify or deal with practices of 'redlining' or discrimination if these exist in the UK. This is because the data disclosed do not contain information on debt burden or credit history, which are important in determining creditworthiness. However, it is believed that disclosure could support research into the determinants of underinvestment and lending, which in turn would aid by enhancing our understanding of financial exclusion and underinvestment. In particular, it would help identify groups and areas less likely to access financial services. There is little evidence to support or negate the argument that banking disclosure in itself increases lending and investment in deprived communities.

The risks associated with banking disclosure are more difficult to assess, given that opponents have not publicly put forward such risks. We analysed the arguments put forward in the US and arguments put forward in discussions with the UK banking industry. Our analysis suggests that the case against UK banking disclosure legislation, based on the risks it would present, is only partially supported by the empirical evidence. The costs associated with banking disclosure, to the regulator, are likely to be modest. The costs for providers to set up systems to support disclosure may well be considerable, especially for HMDA-type disclosure, though once up and running the costs are likely to be less significant. Banks would have to redact and apply statistical techniques to protect the identity of individual customers. Although there are significant differences between the UK and the US, namely that the UK financial sector is more competitive internationally, more consolidated and less regulated, we do not believe that these differences necessarily preclude greater banking disclosure. We also do not agree that the data disclosed would constitute commercially sensitive data.

That said, we believe that disclosure would likely strengthen our understanding of deprived communities and the phenomena of financial exclusion and drivers and nature of underinvestment. We outline three steps the banking industry could take that would constitute moderate costs and potentially great benefits:

- Banks reporting small business lending in the 2 per cent most deprived electoral wards should disclose this data in their individual CSI reports. Presumably this would involve very limited costs and would indicate how well individual banks serve deprived communities.

- As part of its planned publication of small and medium sized enterprise (SME) deposits and lending by postcode area, we would strongly recommend that the BBA discloses the total number of applications. This would enable policy-makers, researchers and other stakeholders to identify root causes of exclusion in an area (i.e. low demand or high proportion of failed applications).

- We recommend that the BBA extends the publication of industry data on postcode area basis to include mortgages (applications and loans) and bank accounts (applications, accounts opened).

While it might be helpful to have this data on smaller geographical areas, the costs combined with the limited evidence for broader positive effects of disclosure suggest that this level of disclosure may be the most appropriate way forward. Combined, these three measures would enable researchers and policy-makers to better understand the nature and drivers of financial exclusion and underinvestment in areas.

Notwithstanding this, we acknowledge that there may be political arguments for introducing disclosure. In particular, there is an argument that anchors disclosure within a rights and accountability framework, within which citizens have rights to financial services and financial institutions should be held accountable for their behaviour regardless of whether disclosure is effective per se.

Chapter 1
Background, aims and method

SUMMARY

Banking disclosure involves disclosure to the public of data on lending and investment in geographic areas and to certain groups by individual institutions. Such disclosure is almost unique to the financial sector due to concerns about discrimination against certain communities and the impact this has on economic development in these communities. In the US, financial institutions have been required to disclose their lending and investment in deprived communities since the 1970s. In the UK, there have been numerous calls for disclosure since the late 1990s, but to date there has been relatively limited public debate concerning the merits of disclosure legislation. Suspecting that this may be due to a lack of consideration of the wider implications, this report carefully examines the risks and opportunities associated with introducing such legislation.

Background

This report analyses the risks and opportunities associated with a UK Banking Disclosure Act. We define banking disclosure as the voluntary or mandated disclosure of data to the public on lending and investment in geographic areas and to specific groups by individual institutions. By enhancing our understanding of lending and investment patterns in neighbourhoods, greater banking disclosure is believed to better enable policy-makers to design and target interventions: it may help reveal market failures and influence the development of appropriate policy responses. Disclosure is also intended to influence the behaviour of the disclosers of the information in accordance with policy objectives (e.g. increase lending to certain groups or neighbourhoods) through enhanced market discipline (i.e. no one wants to be seen as the worst performer). The media, general public and interest groups may work with the data to put pressure on financial institutions. It may also support regulators in their monitoring, regulation and enforcement of banking practice.

In the US, financial institutions are required to disclose data on lending and investment by neighbourhood and type of borrower. The 1975 Home Mortgage Disclosure Act (HMDA) requires financial institutions to disclose socio-economic, demographic and loan characteristics and outcome of applications at mortgage applicant level. Similarly, under the Community Reinvestment Act (CRA), financial institutions over a certain size must report on lending to small businesses and to low- and moderate-income communities.

While disclosure is common across various industries – the food industry discloses information about the nutritional content of its products and companies listed at the London Stock Exchange disclose certain information about their financial performance – the disclosure of data on service provision by geographical area and customer characteristics is almost unique to the financial sector. Why are banks subject to such demands when most, if not all, other sectors are not? We do not expect supermarkets or other retailers to do so, but as will be detailed below there has been longstanding pressure in the UK for greater transparency by the financial sector, while in the US disclosure has been enshrined in law since the 1970s. A number of factors coincide to explain this situation but the impetus for these differs between the two nations. In the US the impetus came from the civil rights movement and the sense that financial institutions were engaging in direct or indirect racism. For the UK the lack of competition in the sector and focus on shareholder value led to a suspicion that some banks are avoiding serving low-income areas and clients due to modest or no profitability.

Neither of these factors adequately explain why the financial services industry has been the target for greater disclosure. We would suggest this has been a product of the history of banks and their success in the second half of the twentieth century. When banks began to emerge they were designed to serve the interests of the aristocracy and the emerging industrial classes. For the remainder of the population banks appeared distant and aloof organisations with a reputation of being part of any local and regional power nexus.

In response, a range of new providers was established that served those on more modest income. In the US these were the savings and loans companies, and the credit unions, while in the UK it was building societies and penny savings banks. For many years these institutional arrangements ran parallel to each other, though it was always recognised that the banks were the dominant (in terms of economic and political power) sector. The popular perception was presented by Hollywood in the film *It's a Wonderful Life*, where the humble savings and loan institution is starved of support by the local bank. Only at the last minute and with the assistance of the whole town does the savings and loan company survive. The message of two diametrically opposite institutional cultures could not be clearer.

As the mid twentieth century progressed the banks gradually increased their marketing and attempted to reach more middle class households (though this was predominantly male members of the household). This did not alter the banks' image of staid, solid institutions (both physically and culturally) managed by paternalistic pillars of the community. The power and autonomy of the bank manager resulted in complaints of prejudice and redlining (a process where whole communities were denied access to banking services). The banks' apparent distance from the wider community and their embeddedness in political and economic power structures made them an obvious site of protest. Echoes of this can be seen today in the supermarket sector where campaigns about the building of new stores are becoming more strident.

But supermarkets are involved in bitter competition and, although the alternatives to them are being obliterated, this is producing lower prices for the customer. Banks also went through a period where they improved their performance and increased market share. The problem was that the 'victims' were the savings and loans companies and the building societies (which converted to bank status). In the UK this reduced competition, with banks, probably the least popular institutional form, the victor. Consequently, the banks were always going to face criticism, not helped by the 2008 banking crisis and the ultimate bailing out of the sector.

Banks differ from supermarkets in another important way: they provide bank accounts, a service that cannot be provided by somebody else, and one that has become increasingly important (almost essential) for everyday life. In 1950, T.H. Marshall argued that in a modern society there are certain services that are necessary for a citizen to actively participate in their society. In 1979, Townsend made a similar point when he explored the concept of 'relative poverty'. Most of the UK population now has access to a bank account (though not all, and the proportion is still below that found in other northern European states) and for many of us it is impossible to imagine life without one. A whole range of unrelated services require a bank account as proof of identity, while yet more services rely on access to a bank account as a means to access price discounts through the direct debit system. It is also difficult to gain employment without a bank account.

So we suggest that the pressure for greater disclosure is a function of banks providing an essential component of modern citizenship, the failure of the market due to the absence of intense and broad competition, and a history of separation and distance (and sometimes exclusion) from the majority of the population. There is no other industry in this position, hence why banks face and, will continue to face, periodic demands for disclosure.

UK calls for greater disclosure date back to the late 1990s

In the UK, the calls for greater disclosure of the service provision of and investment by banks in local communities date back to 1999 when the government-appointed Policy Action Team 3 (PAT 3) on enterprise and social exclusion recommended the disclosure of bank activity in deprived areas. This call was echoed by the Social Investment Task Force (SITF) in 2000 and again in 2003, 2005 and 2010. Greater transparency by banks about the communities they serve and those they do not serve is one of the measures called for by the Better Banking Campaign. Also the think-tanks the New Economics Foundation (nef) and the Financial Inclusion Centre have published reports calling for disclosure (McGeehan et al. 2003; New Economics Foundation 2006; Financial Inclusion Centre 2009).

Despite the calls for and the research into bank disclosure, there has been relatively limited public debate concerning the role and merits of such legislation. In particular, while raised as a possibility from time to time by politicians,[1] there has been no indication, in the form of a government review, green paper or proposed legislation, that government or regulators have seriously considered the possibility of developing such legislation. The recent review of banking regulation by the Independent Banking Commission chaired by Sir John Vickers did not deal with the issue, though it was raised in submissions by nef.

One of the reasons for the reluctance to consider such an act by government and banks alike may be the uncertainty concerning how it would work. In particular, concerns have been raised about the applicability of such legislation, given the differences between the financial sectors in the UK and the US. Ultimately, policy-makers, financial sector representatives and the public may only be able to have rational and serious discussions on the merits of bank disclosure once the implications and options for legislating and enforcing disclosure are properly understood.

Aims of the research

This research project aims to make a contribution towards such an understanding by carefully examining the risks and opportunities associated with banking disclosure legislation. Given the country's long experience of banking disclosure, a central part of the project is an in-depth review of US banking disclosure legislation, regulation and enforcement. Not only is there empirical evidence on its effectiveness, US disclosure legislation has also served as an inspiration for UK advocates of banking disclosure.

Specifically, the project seeks to answer the following questions:

- How are banks and building societies regulated in the UK? What data on lending and investing in deprived communities do UK banks currently disclose?
- How are banks regulated in the US? What data do financial institutions have to disclose and how is the information collected and used?
- How could disclosure work in the UK? What are the risks and opportunities associated with such legislation?

Scope of the research

It is important to make several clarifications regarding the scope of the study. First, it is important to stress that the report is not intended as an evaluation of US disclosure legislation. It is not our intention to assess the extent to which such legislation is appropriate or right for the US. Where we discuss or refer to empirical evidence concerning the effectiveness of US disclosure legislation, our concern is to ascertain if, and the extent to which, disclosure in the UK context would have the effects that its UK critics and proponents claim.

Second, throughout the report we refer to banking disclosure. This does not mean that we necessarily exclusively focus on disclosure by banks. Rather, we use banking disclosure to refer to the geographical disclosure of lending and investment by individual financial institutions. The implication of this is that disclosure could also apply to non-banking financial institutions. In this report, we have also restricted the analysis and discussion to the type of data disclosed in the US and the type of data called for by its proponents (i.e. business lending, mortgage lending and other investment in communities).

Third, while we make some recommendations concerning appropriate UK banking disclosure arrangements, the aim is not to create a blueprint for a Banking Disclosure Act. Rather, we want to take a step back and objectively examine the case for and against disclosure legislation. This includes clarifying what advocates are calling for and how disclosure actually works in the US, and discussing the regulatory and practical implications as well as the potential public welfare benefits of such legislation.

Finally, there may be political arguments for introducing disclosure. In particular, there is an argument that anchors disclosure within a rights and accountability framework, within which citizens have rights to financial services and financial institutions should be held accountable for their behaviour regardless of whether disclosure is effective per se (see for example Financial Inclusion Centre 2009). While we recognise that such an argument might form the basis of introducing disclosure, it was not part of the scope of this study to examine this argument.

Methodology

The methodology consisted of interviews with key stakeholders and experts, and a review of documentation and literature. This methodology has been applied in three areas: an in-depth review of US disclosure legislation, regulation and enforcement; a review of the US and UK financial sectors' composition and regulation; and an analysis of risks and opportunities for a UK disclosure act.

Report outline

This report presents the findings, conclusions and recommendations of the research. It is structured as follows:

Chapter 2 looks at current practice in banking disclosure in the US and UK. The chapter also examines exactly what proponents of disclosure in the UK are calling for.

Chapter 3 critically examines, analyses and discusses the opportunities associated with disclosure.

Chapter 4 critically examines, analyses and discusses the risks associated with banking disclosure.

Chapter 5 summarises and concludes based on the analysis of risks and opportunities. We also make some recommendations on banking disclosure in the UK.

Appendix I contains an analytical template used in the analysis of the risks and opportunities of banking disclosure.

Appendix II details current disclosure arrangements by the UK financial sector.

Appendix III describes the financial sector in the US and the UK

Appendix IV details financial sector regulation in the US and the UK.

Chapter 2
Banking disclosure
Current practice in the US and UK

SUMMARY

The definition of banking disclosure we have adopted for this report stresses that (a) the data must be available to the public and (b) it must be disclosed by individual institutions. In the US, financial institutions have been required to disclose data on lending and investment since the 1970s. This includes disclosing socio-economic, demographic and loan characteristics and outcome of applications at the level of the mortgage applicant under the 1975 Home Mortgage Disclosure Act (HMDA) and on lending to small businesses and to low- and moderate-income communities under the 1977 Community Reinvestment Act (CRA). Current practice in banking disclosure in the UK is uneven, not standardised and not broken down to specific geographical areas.

Introduction

This chapter explores the current practice in banking disclosure in the US and the UK. We first examine disclosure in the US and then in the UK. Two essential components of disclosure, relevant to this chapter, are that it involves disclosing data to the general public; and the data disclosers must be *individual* institutions, not groups or sectors of institutions.

Banking disclosure in the US

In the US, community investment data disclosure requirements for financial institutions are among the most comprehensive in the world. Our review of banking disclosure in the US focuses on the two key pieces of bank data disclosure legislation – the Home Mortgage Disclosure Act (HMDA) of 1975 and the Community Reinvestment Act (CRA) of 1977.

Redlining led to the introduction of disclosure in the US

While the United States requires banks to report extensive firm-level data on their financial condition, regulations in the US also require banks to report more detailed, geographically specific data on lending activity. These data disclosure laws were a policy response to long periods of geographic discrimination in access to credit, known as redlining, in which financial institutions denied access to credit to minority communities. This practice led to the rapid disinvestment in minority communities in urban areas and in turn led to the passage of a set of anti-discrimination laws in the 1970s. The two laws passed during this era with the most significant data disclosure requirements are the HMDA of 1975 and the CRA of 1977.

The Home Mortgage Disclosure Act

The primary financial data disclosure law for lending in the US is the HMDA. This requires the vast majority of banks and non-bank financial institutions that originate mortgages to collect data on mortgage applications that they receive and the loans they originate and report these data to their respective regulatory agencies each year. This data is then collected by a centralised entity, the Federal Financial Institutions Examination Council (FFIEC) and made available to the public at the loan application level. The primary goals of collecting HMDA data and making it available to the public are to determine whether financial institutions are serving the credit needs of all communities, to help enforce anti-discrimination laws, and to guide housing investment to underserved markets.

HMDA data is required to be reported by the vast majority of mortgage lenders active in the United States. Depository institutions with over US$40 million in assets and a branch office in a metropolitan area that have also originated at least one mortgage loan in a given year are required to report HMDA data for that year. For non-depository institutions, any institution that has a physical presence in a metropolitan area or takes loan applications from a metropolitan area and also passes certain thresholds for mortgage lending activity and firm size are required to report HMDA data. In 2009 there were 8,124 lenders who reported data under HMDA, and it is estimated these data represent roughly 80 per cent of the mortgage market (see Avery et al. 2007). Because of the nature of the reporting requirements, urban areas have much higher levels of coverage than non-metropolitan, rural areas.

Financial institutions are required to report detailed, loan application-level data under HMDA. This data includes information on the mortgage application (including the outcome of the application, the type of mortgage, the purpose of the loan); the property (including the census tract location[2] of the property, the type of property, and whether the property is owner occupied); the applicant (including the applicant's race, ethnicity,[3] gender, and income); and basic characteristics of the loan (including loan amount and if the loan was a first or junior lien). If a mortgage is considered 'higher cost', the lender must also report the loan's rate spread, or the difference between that loan's annual percentage rate (APR) and Treasury securities of comparable maturities.[4]

Additionally, if a loan is sold after being originated, information on the purchaser of the mortgage is collected. Also, for loans that are denied, lenders have the option of reporting the reason for denial.[5] The data does not include identifying characteristics such as the mortgage applicant's name or property address.

Since its passage in 1975, HMDA has frequently been enhanced and expanded to ensure that the data collected under the Act are responsive to changes in the lending industry. For example, in 1987 and 1989, in response to the growing number of non-bank mortgage lenders, the Federal Reserve Board expanded the types of institutions required to report data under the Act to include subsidiaries of banks and non-bank mortgage lenders. In 1989, in response to concerns that minority borrowers and women were being disproportionately denied loans, the Federal Reserve Board expanded the data collected under the Act to include information on the outcomes of loan applications and the applicant's income, gender, and race.

In 1992, the Board required that loan application-level data be made publicly available as opposed to reporting the data aggregated at the census tract level. The most recent changes in HMDA data reporting were enacted in 2004. In response to concerns that the rise of subprime lending had shifted fair lending concerns away from disproportionately high denial rates for minority borrowers to minority borrowers disproportionately receiving abusive subprime loans, the Federal Reserve Board required that lenders report pricing data on loans defined as 'higher cost'.

Community Reinvestment Act

When it was initially passed in 1977, the Community Reinvestment Act (CRA) was designed to discourage redlining and to encourage banks to lend, invest, and offer retail banking services in all communities, including low- and moderate-income communities, consistent with safety and soundness. CRA was not designed as a data disclosure law, but over time regulators have used their authority to require that banks collect and report data to help enforce the Act. The most substantial and standardised data collected under CRA relates to small business and small farm lending. Regulators also collect data on other CRA-eligible activities as part of their examination of individual banks; however, the reporting of this data is not consistent or standardised. Additionally, bank examiners monitoring CRA compliance analyse mortgage lending data collected under HMDA or bank branch data collected by the Federal Deposit Insurance Corporation (FDIC) to help analyse bank presence in low- and moderate-income markets.

The US Congress passed the CRA in 1977 in response to concerns that banks were redlining minority communities, leading to disinvestment and decline in these areas. Community advocates and policy-makers were alarmed that banks with branches in lower income and minority communities would take deposits from neighbourhoods, but not reinvest or lend this money back to the community. CRA requires that bank regulators assess 'an institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighbourhoods consistent with safe and sound banking practices.'[6]

A bank's CRA compliance is reviewed regularly every two to three years as well as when it petitions to merge with another financial institution or seeks to open a new bricks-and-mortar branch location. A less than satisfactory CRA evaluation could lead to the rejection of the applications for these activities. The CRA covers commercial banks and thrift institutions and is implemented by the three federal bank regulatory agencies – the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation.[7]

Since its passage in 1977, the CRA has been updated on a number of occasions. The regulatory agencies charged with examining bank compliance with CRA periodically review the CRA regulation to ensure that CRA is responsive to the needs of the community and the industry. A number of substantial overhauls of the CRA regulation have taken place that have responded to concerns of both advocates and bankers.

The most substantial reforms to the CRA regulation took place in 1995. These changes shifted the way that banks were evaluated under CRA to consider the outcomes of CRA activities as opposed to the development of plans to meet the needs of low- and moderate-income communities.[8] This revision to the CRA regulation also divides up the CRA performance exam into three weighted tests for large banks – the lending, service, and investments tests.

The lending test examines a bank's provision of mortgage, small business, and community development loans to low- and moderate-income borrowers and in low- and moderate-income communities. The service test examines a bank's provision of retail banking services through branches, ATMs, and the Internet to low- and moderate-income individuals and communities. The investment test examines the level of investment in and grants to projects and organisations that conduct work in low- and moderate-income communities.

To better evaluate bank performance on these tests, regulators require that banks report data on small business and small farm lending activity. Regulators also make public the resultant CRA performance evaluations and include data on other types of lending and community development activities in which banks engage.

Regulators require that 'large banks', as defined by the CRA regulation, report data on their small business and small farm lending (referred to as 'small business lending data' going forward). Small business lending data reporting under CRA is defined by the size of the loan rather than the size of the business receiving the loan. Banks are required to report the number and dollar amount of loans of US$1 million or less made to businesses of any size. Banks must also report the number and dollar amount of these loans to 'very small businesses', which are defined as businesses that generate less than US$1 million in annual revenue.

While data on small business lending is publicly available, the form in which it is available is much less granular than data made available to the public under HMDA. For example, data is available only for originations and not on the outcomes of small business loan applications. Additionally, data is not available at the loan level, but rather is available only as aggregated at the census tract level.

This census tract level data is not available for individual lenders, but only for the aggregate of all lenders that reported data. For individual lenders, there is aggregate data available for their lending in census tracts grouped by tract income level. For example, for a specific lender, an analyst would know the number and dollar amount of small business loans made to low-, moderate-, middle-, and upper-income tracts in a particular metropolitan area and would also know the number of small business loans to 'very small businesses'.

Small business lending data is also limited because the institutions that report data make up only a portion of the overall small business lending industry. For 2011, only banks and thrifts with over US$1.12 billion in assets were required to report small business lending data. Prior to 2005, all banks with over US$250 million in assets were considered 'large' for purposes of CRA. In 2005, however, regulators created a new designation for banks with between approximately US$250 million and US$1 billion in assets.[9] These institutions are called 'intermediate small' banks and are no longer required to report small business lending data.

While banks supported this change because it reduced their regulatory burden, researchers and advocates who used small business lending data opposed the change because these intermediate small banks are substantial small business lenders whose lending frequently focuses on the communities near where the banks were based. By removing these banks from the universe of institutions reporting data, the data becomes incomplete, and any analysis of it only gives a partial picture of what is happening in the market. It should be noted that CRA small business lending data does not require lenders to report information on the race, ethnicity, or the gender of the business owner or information on the racial or ethnic composition of the census tract in which loans are made by specific banks.

In addition to small business lending data, other data is collected by bank regulators when they examine institutions for compliance with CRA. This data is made publicly available through each individual bank's performance evaluation, which is published on the bank regulator web sites. Regulators regularly collect data from banks on their levels of community development lending, investments and grants provided to non-profit organisations, and access to retail banking services in low- and moderate-income communities. For example, an individual could download the most recent CRA exam for XYZ bank and learn about the community reinvestment activities of this institution. However, its collection is not standardised and can vary substantially institution by institution. Additionally, inclusion of these data in the public performance evaluations of banks is inconsistent (see for example Smith et al. 2007).

Banking disclosure in the UK

We now turn to banking disclosure in the UK. Although we recognise that data collected and disclosed on an industry level does not constitute full disclosure, we also focus on such data because of its practical implications. In other words, if the data is already collected one would not need to invest resources in collecting the information.

Data collected and disclosed by regulators

Regulatory authorities in the UK are currently collecting a wide range of data. The Bank of England collects and discloses a wide range of data (in aggregate form for the sector) on bank deposits and lending to individuals and businesses (including broken down to small and medium businesses), including average and median interest rates, lending outstanding and approved, and loan repayments. Between 1991 and April 2004, the Bank of England monitored the availability of bank finance to small and medium sized enterprises (SMEs) to identify areas where the access to such finance seemed problematic. This work resulted in the publication of a range of reports looking at access to finance in deprived communities, ethnic minority firms and SMEs more generally (see for example Bank of England, 2000, 2002, 2003 and 2004). Again, the data disclosed is for the overall banking sector and not for individual banks.

The Financial Services Authority (FSA) also collects a wide range of data from banks, building societies and the other firms it regulates. The perhaps most pertinent set of data is collected through the Mortgage Lending and Administration Return (MLAR). Firms that are authorised by the FSA to undertake regulated mortgage lending and/or regulated mortgage administration are required to report on regulated and unregulated residential lending on a quarterly basis through the MLAR. The FSA defines regulated lending as 'a loan to an individual, secured by a first charge on residential property, and where the property is for the use of the borrower or a close relative'. Non-regulated lending 'includes buy to let lending, second charge lending and, in some cases, further advances on loans that were originally taken out before regulation came into effect'.

Through the MLAR, firms provide the FSA with data on:

- *Type of loan:* Number and value of outstanding and agreed loans broken down to regulated and unregulated lending, securitised and unsecuritised.
- *Characteristics:* Loan-to-value for loans, income multiples and loans to borrowers with an impaired credit history.[10]
- *Purpose:* Lending for house purchase, remortgaging and buy-to-let.
- *Cost:* Average and median variable and fixed rate.
- *Arrears and repossessions:* Number of new arrears cases,[11] loan accounts in arrears, number of cases given temporary concession (suspended or reduced payments agreed with lender), formal arrangement (to capitalise arrears or increase monthly payments to reduce some or all of existing arrears) and the performance of loans in arrears (payments received in the quarter as a percentage of payments due) and capitalisation (adding part of or all arrears to outstanding principal). Number of possessions (lender granted a Possession Order by a court), including new cases taken into possession, sales of possession cases and stock of possession cases

The FSA reports on this data on a regular basis. However, the data is not broken down by institution.

Voluntary banking disclosure

The BBA discloses industry data on mortgages, personal loans and credit cards on a monthly basis. This trade body also provides information on business lending on a regional level. The BBA will shortly publish SME deposits and lending on a postcode area level on an annual basis. In terms of disclosure by individual institutions, most banks will provide some data on the provision of financial services in deprived communities on a voluntary basis. For example, the Lloyds Group produced a financial inclusion report in 2009 citing some figures on lending and the provision of banking and transaction services in deprived communities. Similarly, Barclays Bank Plc produces an annual citizenship report that covers lending in deprived communities and to small businesses.

However, the current level of disclosure does not lend itself to making comparisons between the providers or identifying areas of underinvestment or excluded groups. The level of disclosure is very uneven across the banking sector. Some institutions disclose data on lending to small businesses in the most deprived communities, while others only disclose grants to community projects. Furthermore, current disclosure is also irregular. Some financial institutions disclose certain information in some years but not in others. Disclosure by financial institutions and their trade bodies is explored in Appendix II.

One financial institution that stands out in terms of disclosure is Fair Finance, a community development finance institution (CDFI)[12] in East London (see box).

FAIR FINANCE – GOOD PRACTICE IN DISCLOSURE

Fair Finance, a CDFI based in east London, discloses lending data, loan volume and amount lent across each borough in which it operates. This is done through its website and is widely available to the public. Fair Finance believes that transparency and accountability are important to tackling financial exclusion and so has chosen to make this information available and share what it considers to be best practice policy. It is the first known online map of disclosure and is seen as a useful tool both for policy-makers and investors. The data is broken down into personal and business loans and is available from the inception of the CDFI in 2005; however, data for individual years is unavailable.

Fair Finance has received praise for its online disclosure from banks, investors and policy-makers alike. The Social Investment Task Force (SITF), commissioned to assess how best to create economic growth, employment and an improved social fabric across the poorest communities, praised Fair Finance as an example to other financial institutions due to its commitment to and high standard of disclosure.

For more information see http://www.fairfinance.org.uk/where/

Conclusion: UK banking disclosure is incomplete and uneven

In summary, the disclosure of data on lending and service provision to specific geographical communities and groups by regulators and by the banks themselves in the UK is uneven and insufficient to (a) identify lending to certain groups and specific geographical areas, and (b) assess and compare banks' lending in deprived communities.

The data disclosed:

- is currently not broken down to geographic areas or by the characteristics of the customers or applicants;
- does not include applications and the outcomes of applications;
- is not broken down by institution.

In comparison with the US, the small business data collected and disclosed on an aggregate basis is more detailed, though it excludes the exact location. The mortgage data collected and disclosed on an aggregate basis in the UK is generally less detailed in terms of the characteristics of the applicant. Also, as far as we know, the data does not include location of property purchased or refinanced or any information on applications.

Chapter 3
The opportunities associated with banking disclosure

SUMMARY

The calls for disclosure vary considerably in nature and magnitude. Some call for individual banks to disclose lending in the most deprived communities, which they already do on an industry level. Others argue for much more comprehensive geographical and customer-level disclosure along the lines of that required in the US. Our analysis suggests that the case for UK banking disclosure legislation, based on the opportunities it would present, is only partially supported by the empirical evidence. UK banking disclosure along the lines of US disclosure would on its own not be sufficient to identify or deal with practices of redlining or discrimination if these exist in the UK. This is because the data disclosed does not contain information on debt burden or credit history, which are important in determining creditworthiness. However, it is believed that disclosure could support research into the determinants of underinvestment and lending, which in turn would aid by enhancing our understanding of financial exclusion and underinvestment. In particular, it would help identify groups and areas less likely to access financial services. There is little evidence to support or negate the argument that banking disclosure in itself increases lending and investment in deprived communities.

Introduction

In this chapter, we critically examine the case put forward for greater banking disclosure. We look in detail at what the proponents of banking disclosure call for. We then scrutinise the arguments for disclosure and the extent to which these arguments are supported by empirical evidence. Finally, we pass a verdict on the arguments, drawing on this discussion.

What do proponents of such measures call for?

There are four main groups that have called for banking disclosure in the UK. These are researchers linked to the think-tank nef (McGeehan et al. 2003; New Economics Foundation 2006), the Policy Action Team on enterprise and social exclusion (Policy Action Team 3 1999), Social Investment Task Force (SITF) (2000, 2003, 2010) and the Financial Inclusion Centre (2009). Other groups, such as the Better Banking Campaign, have also called for banks to disclose who they lend to, but these groups have not produced any specific proposals on how this is to be realised.

Before examining the arguments for disclosure it is necessary to discuss and clarify precisely the nature and extent of banking disclosure called for by these proponents. Specifically, the focus is on their recommendations regarding the data that they propose should be collected, the geographical level of disclosure, collection and monitoring, and incentives, disincentives and enforcement.

Greater disclosure of lending in deprived communities

All the reports argue that banks should disclose information on lending and other activity in deprived communities or areas of underinvestment. However, the reports vary greatly in the level of detailed recommendations on the type of data that should be disclosed and the geographical level at which the data should be disclosed. Policy Action Team 3 (PAT 3) (1999: 82) and SITF (2000: 6) are least explicit in the type of data they would like to see disclosed, calling for monitoring of 'the character and volume of bank and CFI [Community Finance Initiative] activity' and 'more detailed information about the lending pattern of individual banks' respectively. McGeehan et al. (2003) recommend that banks should individually disclose the data they disclose as a group in the reports by the Bank of England. Additionally, PAT 3 (1999) argues that the nature and volume of activity of CDFIs as well as banks in deprived communities should also be monitored. McGeehan et al. (2003) add that banks should also disclose direct and indirect investments in CDFIs.

The most recent reports by nef (New Economics Foundation 2006) and the briefing by the Financial Inclusion Centre (Financial Inclusion Centre 2009) are the most explicit in their recommendations concerning the data that should be disclosed.

According to nef banks should disclose small business deposit taking and lending, basic bank accounts and branch locations on a local-area basis comparable with the Index of Multiple Deprivation, and personal lending on an area basis, including aggregate information on gender and ethnicity. In this report, nef also recommends that banks should disclose a range of data on basic bank accounts, including declined applications, patterns of usage, account dormancy, local area of account holder and costs of servicing the account. It is also the only report that explicitly calls for disclosure on a local-area basis including both deprived and non-deprived communities.

The Financial Inclusion Centre recommends that financial institutions disclose data relating to the following:

- bank accounts (basic and current accounts by income level, gender and ethnicity including applications and rejected applications);
- lending (mortgages, other secured lending and unsecured lending by income level, gender and ethnicity including applications and rejected applications);
- loan values and cost (prime and subprime loans by income level, gender and ethnicity);
- treating borrower fairly (arrears, possessions and charging orders by income level, gender and ethnicity);
- lending to SMEs (by loan values and annual revenues of firms);

- community development lending and investment (lending for social housing, regeneration loans and other CSR activities).

The Financial Inclusion Centre (2009) argues that 'where appropriate, the relevant data should be collected and published at bank branch level, Super Output Areas (or postcode, ward or borough level) and UK corporate level (i.e. data for overall financial institution).'

Disclosure should be mandatory

In terms of the organisation and regulation of banking disclosure, the reports generally call for disclosure mandated by regulation or legislation. PAT 3 (1999: 82) is the only group calling for voluntary disclosure, stating that 'banks should be encouraged to work with interested parties on voluntary disclosure of activity in this area'. In its first report, SITF (2000: 6) argued that disclosure should be voluntary at first, but be required 'if voluntary disclosure is not made quickly'. Subsequent reports by SITF called for mandatory disclosure along the lines of US disclosure regulation. Similarly, in its first report on disclosure, nef called for disclosure on a voluntary basis 'unless it becomes clear after not more than one year that it was not prompting action across the whole of the banking sector' (McGeehan et al. 2003: 15). In its subsequent report, the think-tank recommended that the Government should consider introducing mandatory disclosure (New Economics Foundation 2006). In its report, the Financial Inclusion Centre (2009) also called for mandatory disclosure.

Proponents vague on organisation of disclosure

The reports are generally not very specific on how the disclosure would work. PAT 3 (1999: 82) suggests that 'there may also be a useful additional role for an informed independent body not directly connected with policy delivery to monitor the character and volume of bank and CFI [Community Finance Initiative] activity in deprived areas.'

McGeehan et al. (2003: 15) argue that 'if the disclosure agenda is to move forward there needs to be effective ways of incentivising good bank performers within this arena.' The authors put forward three tests that would maximise the potential of disclosure:

- *Investment test:* Would focus on lending in 88 most deprived local authority wards.
- *Information test:* Would focus on the amount of additional useful information provided by banks.
- *Action test:* Would involve a qualitative assessment of strategies enhancing access to finance in deprived communities (e.g. product development, referral partnerships, shared branch facilities or transfer credit histories).

The first SITF report called for the development of a rating system to reward good performance. However, since then both nef and SITF argue for disclosure along the lines of the CRA in the US. Disclosure under CRA covers mainly small business and farm lending. Additionally, bank examiners monitoring CRA compliance analyse mortgage lending data collected under HMDA or bank branch data collected by the FDIC. Presumably nef and SITF also refer to the data collected under HMDA, though this is not made explicit.

The Financial Inclusion Centre (2009) called for disclosure to be included in the Equality Bill, which was going through Parliament at the time when the centre published the briefing. The FSA, the centre proposed, would be covered by the Bill and would be given an explicit duty to promote financial inclusion. Individual financial institutions would be subject to independent statutory financial inclusion audits, which 'would perform a similar role to the powerful Community Reinvestment Act (CRA) and Home Mortgage Disclosure Act (HMDA) in the USA' (Financial Inclusion Centre 2009).

In summary, the proposals outlined in the reports would involve disclosure ranging from disclosing bank lending in deprived communities as currently reported for the industry as a whole to comprehensive geographical and customer-level disclosure.

What are the opportunities associated with banking disclosure legislation, and are they supported by empirical evidence?

Having looked at the nature and magnitude of disclosure called for by its proponents, we now turn to the main opportunities associated with disclosure which are that disclosure prevents redlining, enhances our understanding of deprived communities and increases lending and investment in deprived communities. We examine the extent to which these arguments are supported by empirical evidence.

Disclosure prevents redlining

One of the main opportunities associated with disclosure is that it would help detect and prevent the practice of redlining and discrimination in lending and service delivery. Indeed, this was the reason for the introduction of HMDA, CRA and other fair lending regulation in the US in the first place. In particular, there was a concern among US policy-makers that banking institutions were accepting deposits from households and businesses but ignoring qualified loan applicants and lending in the very same communities, especially in low-income and ethnic minority communities.

Redlining in the US context is defined by D'Rozario and Williams as a:

> practice that used to be employed by banks and insurance companies in the United States. … Firms in these industries, when they employed this practice, would decide that they were not going to serve certain neighbourhoods, if they were composed primarily of ethnic-minority households, regardless of their creditworthiness or insurability.
>
> (D'Rozario and Williams 2005)

Evidence suggests that redlining and discrimination have taken place in financial service provision in the US. For example, a 1996 study by Munnell et al. (cf. Winston 2008) found that race played a role in lending decisions – given the same personal and financial characteristics, white applicants enjoyed a general presumption of creditworthiness that Hispanic and African American applicants did not.

It is acknowledged that there is no evidence to suggest that the practice of redlining exists in the UK (McGeehan et al. 2003; Social Investment Task Force 2000). On the basis of its review of existing evidence, PAT 3 (1999: 66) stated that 'it probably cannot be concluded that there is discrimination on part of banks, but there is clearly a perception among black and minority ethnic (BME) groups that they are likely to face discrimination from banks.' This is also supported by available econometric evidence. For example, Fraser (2005a) found that the refusal of business credit reflected the characteristics of their businesses rather than the ethnicity of their owners.

However, it is generally acknowledged that there are market failures affecting the access to financial services in deprived areas and for certain groups (GHK 2010; Policy Action Team 3 1999), especially women and ethnic minorities. It has been argued that customers in certain areas have been priced out of accessing certain products (e.g. insurance) and that the withdrawal of bank branches indicates differing access to finance for deprived and affluent communities (McGeehan et al. 2003). In their study of the availability of free cash machines, Khan and Simpson (2009) find that areas with large BME populations have worse access to free cash machines. The study finds that ethnicity was the most important determinant of access to free cash machines, even more important than deprivation (Khan and Simpson 2009).

In its report to the Treasury, the Policy Action Team (PAT 3) on enterprise and social exclusion concluded that there was a finance gap in deprived communities. This was, according to PAT 3, due to higher objective lending risk, greater information asymmetries and more costly monitoring. PAT 3 argued that even if these were to be rectified, there would be a finance gap as lenders would not take into account the positive externalities and spillover effects associated with lending to and investing in these communities. It recommended that 'the Government monitor the character and volume of bank and CFI [Community Finance Initiative] activity in deprived areas, to maintain pressure for change' (Policy Action Team 3 1999: 82). McGeehan et al. (2003) and nef (2006) reached similar conclusions.

As discussed above, available evidence does not suggest that redlining or discrimination is taking place in the UK. Econometric studies show that, when controlling for business characteristics, there is no significant difference between firms in deprived areas in the access to finance relative to non-deprived areas (Cosh et al. 2008), female-owned businesses do not experience more difficulties in obtaining start-up finance (Roper et al. 2006; Sena et al. 2012) and ethnic minority entrepreneurs do not experience more difficulty in obtaining business finance (Fraser 2005a). That said, there is evidence to suggest that women (Sena et al. 2012) and individuals of an ethnic minority background (Fraser 2005a, 2005b) are less likely to seek external finance for business start-ups. For a fuller discussion of market failures in business finance provision see the literature review by Dayson in GHK (2010).

One could say of course that until the data is collected and disclosed we do not know if discrimination actually occurs. In the US, regulators use HMDA data as an indicator to identify possible discriminatory lending patterns for institutions that may have violated fair lending laws. The US Justice Department receives referrals from bank regulators about possible fair lending violations and uses HMDA data analysis as one piece of evidence in its investigations.

However, as noted by, among others, Winston (2008), Ross and Yinger (1999), and Doviak and MacDonald (2011), the data collected and disclosed under HMDA is not sufficient to judge whether discrimination occurs in financial service provision, as it does not include information on collateral, loan-to-value ratio, credit history or debt burden which are important factors in determining credit worthiness. It is also argued by some that discrimination is not a market failure but unlawful behaviour that would be addressed via proper legal mechanisms (White 2008; Winston 2008). The same logic applies to the data collected under CRA. Lower levels of lending and investment in an area relative to another do not necessarily mean that redlining or discrimination is occurring, as the variation may be explained by economic factors, such as credit worthiness of residents.

That said, disclosure along the lines of US disclosure would enable the identification of groups and areas less likely to be served by mainstream financial institutions. This, in turn, could be used to indicate where further investigations of discrimination might be required.

In conclusion, disclosure is unlikely to, in isolation, be helpful in detecting and preventing redlining and direct discrimination if this indeed exists in the UK. However, there may be a wider use of such data in detecting groups that are experiencing financial exclusion and spur greater lending to these groups. We discuss this in greater detail below.

Disclosure promotes greater understanding of deprived areas

Another oft-cited opportunity associated with greater disclosure is that banking disclosure promotes greater understanding of local markets, especially deprived communities (McGeehan et al. 2003; New Economics Foundation 2006; Policy Action Team 3 1999; Social Investment Task Force 2000, 2010). Because financial exclusion and underinvestment are spatially located, it is argued that this greater understanding of local areas and their problems will enable the development of more effective interventions and better targeting of scarce resources to deprived communities (Social Investment Task Force 2000; New Economics Foundation 2006). It can facilitate the measuring and benchmarking of progress in funding community regeneration in different areas (Social Investment Task Force 2000).

Further, the enhanced understanding of local needs may improve partnerships between community organisations and local representatives of the financial services sector, such as referral partnerships and better-tailored investment readiness training by local enterprise agencies (McGeehan et al. 2003). McGeehan et al. (2003) suggest that it is also a useful exercise for the banks themselves, enabling them to develop new products to serve these markets better.

Ultimately it is difficult to judge what type of information is useful and what is not. A good proxy of usefulness is the extent and nature of use of the data. According to Fung et al. (2004), the effectiveness of disclosure depends on the information disclosed becoming embedded in the decision-making routines of its users and disclosers.

The data collected under HMDA is regularly used by a wide variety of stakeholders. Federal regulatory agencies use HMDA data to examine the performance of specific banks in meeting the credit needs of low- and moderate-income individuals and communities as part of examinations performed under the CRA. Government agencies have also used HMDA data to target resources and investment. A recent example includes using HMDA data as an indicator to identify communities with high foreclosure risk and target those communities for foreclosure mitigation resources.[13]

Researchers and advocates also regularly use HMDA data to characterise aspects of local mortgage lending markets, to identify disparate lending patterns and to examine the lending patterns of specific financial institutions. A substantial body of research using HMDA data has been developed identifying disparate lending patterns between white communities and communities of colour. Using HMDA data for the period 1993–98, Immergluck and Wiles (1999) found that, controlling for median house value, income and educational level of borrower, African American and Latino households and communities were more likely than white communities to receive higher cost subprime loans.

Conducting descriptive statistical analysis of 2005 HMDA data on seven large mortgage lenders in six metropolitan areas, Campen et al. (2007) found that bank holding companies with multiple lending affiliates used affiliates who specialised in lower cost, prime lending to make loans in white communities, while using affiliates that specialised in higher cost, subprime lending to make loans in African American and Latino communities. Recent research by Bromley et al. (2011) involving cross-tabular analysis of HMDA data found that in the wake of the subprime mortgage crisis, communities of colour have seen steep declines in access to conventional mortgage refinance credit and higher denial rates, particularly in comparison to white communities, which saw dramatic increases in recent lending and low denial rates.

The transparency provided by HMDA data allows the public to conduct the types of analyses described above. These analyses were used by stakeholders to raise awareness of abusive subprime lending schemes targeted to communities of colour and to make the case for enhanced regulation of the subprime lending industry. Analysis of HMDA data has also been used in complaints filed by advocacy organisations in protest at bank merger applications. The media has also frequently analysed HMDA data to raise awareness of disparities between white communities and communities of colour in denial rates and access to lower cost loans.[14]

In 2010, the United States Congress passed the Dodd-Frank Act, a major overhaul of financial regulation in the United States. One part of this overhaul was the requirement that additional data be collected under HMDA. These new data variables are meant to address concerns raised above about using HMDA data to analyse variations in lending patterns, loan pricing, and denial rates as well as enhancing its use to detect emerging risks in the mortgage market. The Dodd-Frank Act mandates the collection of additional data on the borrower (such as age), the mortgage terms (such as whether a mortgage was adjustable rate, the loan term, and if there is a prepayment penalty), and the underwriting (such as the loan to value ratio, information on a borrower's credit, and whether the loan was originated through a mortgage broker).

Consumer advocates and many researchers are enthusiastic about the Consumer Financial Protection Bureau's authority to collect improved HMDA data, but these changes also increased concerns about the burden of collecting these additional data points, as well as potential privacy issues. The Consumer Financial Protection Bureau gained HMDA rule-writing authority on 21 July 2010, and is expected to issue implementing rules over the next couple of years.

Relative to the HMDA data, the data disclosed under CRA is seen as less useful. The CRA data is less granular than the HMDA data as it does not include data on business loan applications or on the characteristics of the borrower. The data set is also incomplete as it only includes banks defined as large. Finally, while the CRA disclosure report may include data on other investments by banks in deprived communities, this data is not standardised. Nevertheless, the data disclosed under CRA is still seen as useful and widely used in research and policy.

Hence disclosed data is extensively used in the US, but to what extent would these benefits be transferable? There are uses of the disclosed information that seem unlikely to be transferable to the UK. UK community groups would not use the information in relation to mergers, acquisitions or expansion applications because further mergers are unlikely in the UK. Moreover this would predicate that performance on disclosed information would be taken into account in the consideration of such applications. Similarly regulators would not use the data for those purposes either. It is also questionable if local community groups would have much effect on banks given that UK banks are national rather than local and thus would put much emphasis on monitoring and lobbying banks.

There are other uses that would probably be more transferable. First, it is likely that the release of data similar to that of HMDA and CRA would, as it has in the US, generate a plethora of research. Disclosure of individual bank lending in geographical areas would enable researchers to explore the characteristics of financial service providers that are more or less likely to serve lower income communities (e.g. size, mutual vs. plc, foreign vs. UK ownership, etc.). It would also allow for research into reasons for underinvestment in certain areas (e.g. size, etc.). Similarly data on successful and unsuccessful loan applicants would enable researchers and policy-makers to identify and target groups and areas at the margins of mainstream finance. It might also be used by charities, community organisations, social housing landlords, local authorities and ethical investors to choose provider or investment.

Disclosure leads to greater bank lending in deprived communities

Finally, disclosure, it is argued, incentivises banks to invest in and lend more to businesses and individuals in deprived communities, which in turn stimulates economic development (Policy Action Team 3 1999; McGeehan et al. 2003). Because disclosure on individual banks enables the public, policy-makers and customers to compare and contrast performance, it is believed that banks will seek to enhance their lending to avoid being seen as performing poorer than their competitors.

In financial markets this dynamic is referred to as market discipline, which is defined by Nier and Baumann (2006: 333) as 'a market-based incentive scheme in which investors in bank liabilities, such as subordinated debt or uninsured deposits, "punish" banks for greater risk-taking by demanding higher yields on those liabilities.' In this context, the implication is that investors and customers will punish banks with a poor lending record in deprived communities by selecting better performing banks. This may be particularly relevant for corporate clients, such as social housing landlords, charities and local authorities, who already have a tradition for taking into account community welfare in procuring services. For example, social housing landlords use their leverage as procurers of insurance products to negotiate low rates for their tenants.

However, what evidence is there that disclosure in the US has improved lending in deprived communities? In their case study research of 12 government-mandated disclosure systems in the US, Fung et al. (2004) argue that HMDA 'has proven highly effective in improving access to mortgages by minority groups and inner-city residents'. According to the authors, the information is used by community groups to pressurise banks to lend more to excluded groups and by regulators to develop new regulation, monitor improvements and tighten enforcement. Together with CRA, they claim, HMDA added incentive for banks to respond to the demands of community groups.

However, the findings of Fung et al. (2004) are challenged by Winston (2008: 706) who argues that 'there is no persuasive evidence … proving any of the disclosure policies that [Fung et al. (2004)] consider – or of other information policies they do not consider – have been effective'. A problem with Winston's critique is that he only looks at disclosure. While it may have been the intention of the authors to only focus on disclosure, their argument is that disclosure under HMDA has been effective *in combination with* obligations to reinvest under CRA.

To support his argument that disclosure is not effective, Winston (2008) points to evidence suggesting that mandated corporate financial disclosure has not affected stock returns or produced any other benefit. However, most of the studies he quotes are simple comparisons before and after the introduction of corporate financial disclosure requirements so they do not address the question of what would have happened with stock returns in the absence of the act or what other factors may have affected the fall in stock returns. We would conclude that there is no conclusive evidence, positive or negative, of the effectiveness of disclosure mandates.

One of the difficulties in assessing the effectiveness of banking disclosure on lending and investments in deprived communities is that this is rarely discussed in isolation of the CRA in its entirety. Although it is rarely used – between 1990 and 1996 only 20 out of nearly 55,000 applications for geographic expansion were rejected on CRA grounds (Thomas 2002, cf. Bostic et al. 2005) – a bank's CRA lending record is considered in the review of applications to open new branches or acquire or merge with another institution. Given that the HMDA and CRA were implemented at around the same time it is hard to see how one could isolate the effects of disclosure from community reinvestment obligations (or vice versa).

We therefore discuss the effectiveness of disclosure in conjunction with the wider components of CRA. It is important to note that there is an extensive empirical literature on CRA. For the purposes of this report, we have only reviewed studies that make explicit references to the effect of disclosure.

Bostic and Robinson (2003) examine the effectiveness of CRA agreements. These agreements are made between community groups and banks to ensure flow of credit throughout the area and often include explicit lending targets to lower income and minority individuals and areas. Using panel data for 727 counties for the period 1993 to 1999, the authors explore the extent to which conventional mortgage lending varies with the presence, number, introduction and expiration of CRA agreements (Bostic and Robinson 2003). They found that the CRA agreements were associated with growth in conventional mortgage lending activity to lower income and minority communities and with growth in mortgage lending overall.

However, the increases were short-lived (less than two years), suggesting 'that lenders view CRA agreements as form of insurance against potentially large and unknown costs of fair-lending violations and poor CRA performance ratings' (Bostic and Robinson 2003: 25). Crucially, Bostic and Robinson (2003) argue that the effectiveness of CRA agreements depends on community groups' level and nature of monitoring of compliance, the implication being that the relevant information has to be publicly available.

Using data for 4,800 banks, Bostic et al. (2005) examine if banks self-regulate by increasing CRA lending – defined as the percentage of total home mortgage originations in a year that are to low- and moderate-income neighbourhoods and individuals – prior to merger or acquisition applications for the period 1990–95. They find that the probability of acquisition significantly influenced the proportion of mortgage originations to low- or moderate-income individuals and areas in preceding years. However, the results are only significant and positive for large banks. The authors attribute this to the greater scrutiny of larger institutions by regulators and community groups.

In light of the inconclusive evidence concerning the effectiveness of disclosure in isolation of other regulation, it is difficult to discuss any potential impact of UK disclosure on lending and investing in deprived communities. However, as suggested above, UK banks may be less susceptible to pressure from local community groups as there are virtually no local banks, with the possible exception of some regional building societies.

That said, UK banks may be more susceptible to pressure from national media and pressure groups. Thus, it is possible that the public exposure (and ensuing bad press) of a lack of service provision to certain groups may lead banks to improve their service provision to these groups (e.g. new or improved products, training of staff to deal with a particular group, etc.). For example, Marshall (2004: 248) argues that 'attitudes in the industry have softened and institutions have under pressure become more sensitive about, and slowed the pace of, branch closures', as bank closure has become a major issue in the last few years. It is of course also possible that the release and analysis of data on local lending, service provision and investment may affect bank lending as ethically minded investors and local customers may choose the banks that best serve their community.

Conclusion: The evidence only partially supports the arguments made for the opportunities associated with greater banking disclosure

The case for UK banking disclosure legislation is only partially supported by the analysis of the evidence:

- UK banking disclosure along the lines of US disclosure would on its own not be sufficient to identify or deal with practices of redlining or discrimination, if these exist in the UK. This is because the data disclosed does not contain information on debt burden or credit history, which are important in determining creditworthiness.
- It is believed that disclosure could support research in the determinants of underinvestment and lending, which in turn would aid by enhancing our understanding of financial exclusion and underinvestment.
- There is little evidence to support or negate the argument that banking disclosure in itself increases lending and investment in deprived communities.

Chapter 4
The risks associated with banking disclosure

SUMMARY

The risks associated with banking disclosure are more difficult to assess, given that opponents have not publicly put forward such risks. We analysed the arguments put forward in the US and arguments put forward in discussions with the UK banking industry. Our analysis suggests that the case against UK banking disclosure legislation, based on the risks it would present, is only partially supported by the empirical evidence. The costs associated with banking disclosure to the regulator are likely to be modest. The costs for providers to set up systems to support disclosure may well be considerable, especially for HMDA-type disclosure. However, once up and running, the costs are likely to be less significant. Banks would have to redact and apply statistical techniques to protect the identity of individual customers. Although there are significant differences between the UK and the US, namely that the UK financial sector is more competitive internationally, more consolidated and less regulated, we do not believe that these differences necessarily preclude greater banking disclosure. We also do not agree that the data disclosed would constitute commercially sensitive data.

What are the risks associated with banking disclosure legislation?

The proponents of banking disclosure have explicitly put forward their case in publicly available reports. This enables us to identify who they are and assess the arguments they use. Conversely, the opponents of greater banking disclosure have not published reports laying out their arguments. The reason for this is probably that policy-makers have not signalled an interest in implementing such legislation by issuing a consultation or a white paper. We therefore discuss the criticisms of banking disclosure in the US. We also discuss arguments that have been put forward in discussions with representative of the UK banking sector.

Disclosure produces data of limited relevance at high cost

The greatest objection to disclosure is that it involves high costs, but produces a lot of information that is of limited relevance. In the US, financial institutions cite the compliance costs of collecting HMDA data as one of the primary sources of regulatory burden facing financial institutions.[15] These costs are tied to employing and training compliance staff to collect the data and to ensure its accuracy as well as the costs of computer software that facilitates data input and reporting. While advances in computer software have greatly streamlined the collection of HMDA data, these benefits are often most experienced by large financial institutions that have substantial loan volumes and that can justify investments in technology and dedicated staff.

There are a number of difficulties in measuring costs for regulators and the regulated. First, regulators tend to underestimate costs and the industry tends to inflate them, often by combining transition costs with ongoing costs (Barr 2005). Second, there is paucity in data on costs linked to HMDA, which would probably have the largest effect on regulators and financial institutions in the UK. Some of these costs will most likely be incorporated into CRA costs as banks have to submit HMDA for the preceding two years into the public CRA report. However, there will also be costs on top of CRA. Third, it is difficult to assess the costs linked to introducing HMDA and CRA in the first place as in the US these were introduced a long time ago.

Numerous banking industry trade groups argue that the CRA data collection requirements are burdensome and that this burden disproportionately impacts small and mid sized banks. One industry study in the US reports that 'large' community banks that are required to report small business lending under CRA spend 36.5 per cent more on compliance costs tied to data collection than 'small' community banks that are not required to collect such data (Grant Thornton 2002).[16] These costs are tied to data collection and entry, software, and staff time devoted to compliance-related issues. The report estimates that the mean employee cost for a large community bank is US$115,270 per year and that in a large community bank, staff devote the equivalent of 7.5 weeks of one person's time in total per year for data collection and entry tasks.

While banks cite these costs as a regulatory burden, advocates believe that these costs are modest when considering the size of these banks and the value of the data being reported. For example, a US$115,270 annual data cost is equivalent to 0.05 per cent of the assets held by a US$250 million bank, the smallest size for a 'large' bank in the study.

The report by Grant Thornton also looks at the costs of transitioning from a small to a large bank in terms of CRA regulation. As discussed in Chapter 2, only large banks are required to report and disclose small business data. Hence the transitioning costs may be indicative of costs for UK banking institutions to disclose small business data. According to the report by Grant Thornton (2002), transition costs were in excess of US$100,000 and some of the banks participating in the study reported investing in excess of US$50,000 in software enhancement and purchases. Such costs would largely be one-off and include investments in software and adjustments to existing management information systems.

In 1999, US regulators (cf. Barr 2005) estimated that staff in large banks would spend 554 to 635 hours per year on data collection and reporting under CRA. They calculated that the industry as a whole would spend a total of 1.25 million hours per year, costing US$35.4 million industry-wide (i.e. an average cost per hour of US$28.32). This would constitute between around US$15,700 and US$18,000 in staff costs. This is considerably lower than industry estimates of around US$115,000. Barr (2005) notes that the calculations by the regulators are probably too low as they underestimate the geo-coding costs (i.e. the costs translating each address into a zip code). Barr (2005) argues that because regulators underestimate and providers overestimate such costs, the real figure is likely to lie somewhere in between.

However, this only covers the costs of collecting and disclosing data under CRA. The data collected and disclosed under HMDA is much more extensive. A study by Grant Thornton (1993, cf. Barr 2005) found that the HMDA was the fifth most costly regulation faced by community banks in the US. In comparison, the fifth greatest administrative burden for firms regulated by the FSA was money laundering reporting to the National Criminal Intelligence Service and cost the industry an estimated £38.5 million and the largest 60 firms around £300,000 (Real Assurance Risk Management 2006).

One of the more recent disclosures introduced in the UK, which might offer some indication of cost, is the requirement on financial firms regulated by the FSA to report data on complaints. The FSA then discloses data on a firm level for organisations with more than 500 complaints. Based on a survey of firms, the FSA estimated the costs for the largest 400 firms to supply complaints data to be £565,000 per company as an initial cost and around £300,000 per year in the following years. However, it should be noted that this data is not broken down to a geographical level (i.e. to administrative or statistical area), and the costs of collection and reporting are therefore likely to be lower than the costs associated with a UK equivalent of HMDA.

Ultimately it is difficult to quantify exact costs involved in banking disclosure for financial institutions, as this would depend on a host of factors. Instead we would like to highlight two salient aspects of the costs of disclosure. First, the costs will depend on the geographical level of disclosure. In the US, HMDA and CRA data is reported on a census tract level. This is the smallest area in US statistical geography and the UK equivalent would be a lower layer or middle layer Super Output Area (SOA). There are over 34,000 and 7,000 lower layer and middle layer SOAs respectively in England and Wales. The relevance of disclosing data for SOAs is that the National Office of Statistics produces data on level of deprivation and other data for these areas.

In its 2003 report on lending to small businesses in deprived communities, the Bank of England (2003: 25) observed that the data on lending in deprived communities does 'not occur naturally in [banks'] management information systems'. Disclosing data for these statistical areas would require geo-referencing of the data (i.e. linking postcodes or addresses to SOAs). The banking sector is already able to produce data on a postcode area basis, as evidenced by the BBA's plans to publish data on this level.

A second determinant of costs is the nature and magnitude of the data to be disclosed. The scale of operations increases costs, though the rise in costs is not likely to be proportional due to economies of scale (Bank of England 2006). The banks reporting data to the BBA made around 1.2 million loans and overdrafts by the end of 2010. According to the BBA, the six largest retail banks approved 400,000 mortgages for house purchase in 2010.

In addition to the scale, costs will also vary with the type of information and the complexity. According to research conducted by the Bank of England (2006) reporting on transactions is four times more costly than balance sheet reporting. This is because they require a single read, while transactions require tracking of flows. The data disclosed under US disclosure would be classed as transactions. The complexity refers to the extent to which it fits with existing practice in the institutions. As noted by the Bank of England, data on lending by statistical areas does not occur naturally in the reporting systems of banks. According to research, disaggregated information is twice as costly as reporting aggregated data and reporting detailed information on financial instruments in ways that differ from a bank's own requirements is three times as costly as standard items (Bank of England 2006).

In summary, without putting an exact figure to it, the collating and disclosing of lending by lower layer or middle SOAs would likely be costly relative to other reporting. The costs for providers to set up systems to support disclosure may well be considerable, especially for HMDA-type disclosure. However, according to a representative from the banking sector, once up and running, the costs would likely be less significant.

Turning to the costs of banking disclosure for the regulators, the main entity in the US is the FFIEC, which collects and discloses the data. According to its audited accounts, FFIEC received US$3.4 million, or around £2.2 million, and US$1 million, or around £600,000, in funding for HMDA and CRA respectively. Around 8,100 institutions reported to the agency under HMDA in 2009, and 880 lenders reported data on small business and farm lending under CRA in 2010.

In the UK, there would be fewer lenders reporting data depending on the minimum size threshold for reporting. According to figures cited by the Vickers review, the four largest banks had 85 per cent of the market share of business current accounts (Independent Commission on Banking 2011). There were only two challengers of any meaningful size in this market (Independent Commission on Banking 2011). The number of mortgage providers would probably be higher, although in this market there has been a tendency towards market concentration since 2008 (Independent Commission on Banking 2011).

The regulators involved in the collation and disclosure of the data would most likely be the FSA, or more precisely its successor the Financial Conduct Authority, and the Bank of England. The UK equivalent to the HMDA would most likely fall under the FSA and the CRA disclosure under the Bank of England. This is because mortgage providers report on a regular basis to the FSA, while the Bank of England monitors SME lending by banks. Provided that the financial institutions would submit the data in ready-to-disclose format electronically, one would imagine that no more than one full-time equivalent employee would be required per disclosure act (i.e. one at each regulator in the scenario described above). There would also be considerably fewer institutions reporting under a UK banking disclosure given that there are fewer providers in the first place. It is likely that the lion's share of the costs would be borne by the financial sector.

Banking disclosure is not transferable to UK context

An important objection raised to introducing US-style banking disclosure legislation is that such regulation was designed to deal with a particular problem in a specific historical context.

It is often argued that the US is too different from the UK for banking disclosure to be transferable. In the US, community investment data disclosure requirements were born out of a period in which financial institutions were accused of refusing to make loans in minority communities. There are a number of ways in which the US and the UK differ. Three of these have been highlighted as obstacles for transferring US banking disclosure regulation to the UK: the fact that the UK financial sector is more consolidated; the greater internationally competitive and less regulated position of the UK financial sector; and the greater consumer protection offered to UK consumers rendering disclosure regulation obsolete.

The UK sector is more consolidated

The UK sector is dominated by a handful of financial institutions. The consolidated nature of the sector can be traced back to the wave of mergers and acquisitions from the 1860s to the 1910s, which culminated in the dominance of five large clearing banks by 1918. In 1920 these five banks accounted for 80 per cent of English bank deposits (Collins 1988). From the 1860s to the 1940s, governments accepted the emergence of oligopoly in the banking sector. It was only in 1968 when Lloyds and Barclays Bank announced their intention to merge and subsequently take over Martins Bank that the Government put a stop to mergers in the sector.

In contrast, US governments resisted the emergence of oligopolistic banking markets through low entry requirements and putting in place barriers to cross-state banks. Consequently the number of banks grew from fewer than 12,000 in 1899 to more than 30,000 in 1922 (Ferguson 2009). In recent decades US banking has gone through a process of consolidation. From 1992 to 2010, the number of institutions insured by the Federal Deposit Insurance Corporation (FDIC) fell from nearly 14,000 to around 7,600, but the assets under their control increased from US$4.5 trillion to US$13.3 trillion.[17] As this growth and consolidation occurred, a growing share of banking assets became concentrated in the largest institutions. Between 1992 and 2010, the assets controlled by FDIC-insured institutions with over US$1 billion in assets increased by over 237 per cent, and these large institutions went from controlling 69.2 per cent of FDIC-insured assets to controlling 89.2 per cent of these assets. Nevertheless, while today the US banking sector is more concentrated than it was, it is still much less consolidated than the UK.

There are two main reasons for this difference. First, US governments were fearful – in light of the close links between industry and banking – that unchecked mergers would lead to a concentration of power (Schweikart 1997). In the UK, there were fewer links between banks and industry and thus less fear of the emergence of actors dominating finance (Moran 1986). Second, a string of widespread bank failures in England from 1825 to 1878 made legislators push for larger banks. Financial stability rather than competition has since been a defining feature of the financial sector and its supervision and regulation.

The implications for the applicability of banking disclosure in the UK are less obvious than it might appear. The implications for CRA are clearer and are succinctly summarised by McGeehan et al.:

> This means that the US focus on serving all of the community where a bank is located is less easy to translate to the UK. Meanwhile, the ability to halt mergers in the US does not equate to an effective sanction in the consolidated UK environment.
>
> (McGeehan et al. 2003: 4)

However, there may be a case for banking disclosure without the obligation of banks to serve all of the community where they are based. As discussed in Chapter 3, the disclosure may spur a plethora of research for the benefit of policy-makers, financial institutions and the public. That said, the consolidated nature of the UK financial sector may mean that banks are less receptive to lobbying from local authorities and community groups regarding the access to financial services in the area.

The UK financial sector is less regulated and more internationally competitive

US regulators are more inclined to seek statutory remedies than those in the UK. Consequently there are 'many more pieces of legislation' in the US (Heffernan 2001: 232). In the UK, conversely, there is a much higher threshold for the introduction of new legislation. In carrying out its activities, the FSA must take the principles of good regulation into account. These are related to making most efficient and economic use of resources, and balancing burdens and benefits of new regulation. However, there is one principle that is telling for the UK's approach to regulating the financial sector. It states that the FSA must take into account the international character of the industry and the desire to maintain its competitive sector. The implication of this may be a tendency to minimise the regulatory burden.

Indeed the importance of the financial sector to the UK economy may in part explain why the UK currently has one of the most liberal regulatory frameworks in the Western World. The financial sector has been a key driver of economic growth in the UK over the last 20 years. Between 1987 and 2007 the financial sector grew by 4.5 per cent per year compared to 2.6 per cent for the economy per year (Weale 2009). Indeed, without the higher growth for the financial sector, the growth of the UK economy would have been 0.2 per cent less per year (Weale 2009).

Whilst start-up costs associated with banking disclosure along the lines of US disclosure might be considerable, it seems highly unlikely that they would endanger the competitive position of the UK financial sector.

The UK claims to have stronger consumer protection laws

Another difference that is suggested by the banking industry in the UK is that consumer protection laws are stronger relative to the US and that therefore there is no need for greater banking disclosure. A detailed, comprehensive comparative analysis of consumer protection laws in the US and UK was outside of the scope of this study. Moreover, discrimination and redlining are only one part of the case for greater banking disclosure. Indeed, as we argued in Chapter 3, banking disclosure is, in isolation, not a particularly effective tool to detect and combat discrimination. Other arguments relate to banking disclosure helping to increase lending to, and enhance insight into, deprived communities.

Disclosure would reveal commercially sensitive information

Another important potential risk associated with disclosure relates to the protection of commercially sensitive data. Any disclosure act should not harm the financial institutions or be advantageous to competitors. But what constitutes commercially sensitive data? The most obvious example of commercially sensitive data would be trade secrets. These may include formulae, recipes, names of customers, pricing structure and any other aspect of the business that is the source of the company's competitive edge (Information Commissioner, undated). Whether a product, practice or system constitutes a trade secret also depends on the ease with which competitors can discover or reproduce the information for themselves (Information Commissioner, undated). If the information is known beyond a narrow circle it is unlikely to constitute a trade secret.

It would be hard to argue that the data disclosed in the US would constitute trade secrets. By using the HMDA data, one could tell the proportion of successful applications, mortgage applications and loans issued by geographical area and group (ethnicity, race and sex), and size of loans made. The CRA data would allow one to deduce the number of loans and loan amounts an institution makes to small businesses and farms by geographical area. It does not reveal pricing structure or any other aspect that could (a) be reasonably be considered the source of a bank's competitive edge and (b) not be reproduced with relative ease, though at a cost and with lower precision. However, the data do reveal the market share and position of financial institutions.

Trade secrets constitute only one type of potentially commercially sensitive data. There is also data relating to commercial interests more broadly, defined as information relating to a firm's ability to successfully participate in commercial activity (Information Commissioner, undated). According to guidance issued by the Information Commissioner (undated) to public bodies dealing with Freedom of Information requests, there is a test which should be applied prior to the release of potentially commercially sensitive data – the test of prejudice. The test indicates whether the information is commercially sensitive. If it is, there are grounds for not releasing the data.

The test of prejudice involves answering a series of questions regarding the activity and the information in question:

- *Does information relate to or could it impact on a commercial activity?* Disclosure relates to and may impact on commercial activity.
- *Is commercial activity conducted in a competitive environment?* The UK financial market is concentrated, especially vis-à-vis the US, but there are nevertheless several competitive providers.

- *Would there be damage to reputation or business confidence?* There may be embarrassment for poor performers, but no conceivable impact on stock prices or consumer confidence.
- *Whose commercial interests are affected?* The interests potentially affected would be those of banks.
- *Is information commercially sensitive?* Debatable. Market shares of largest providers are widely known, but disclosure would release more detailed data. It might affect smaller providers whose market share is less well known.
- *What is the likelihood of prejudice being caused?* Relatively low.

The first part of the test is to establish whether the information relates to or could affect a commercial activity. Information on commercial activity relates to the buying or selling of goods and services. The information may have a less direct link to a commercial transaction, such as the relocation of a firm that, if publicly known, might damage labour relations (Information Commissioner, undated). The disclosure in question relates to bank lending to small businesses and farms, by lower layer SOA, the UK equivalent of US census tract, and mortgage applications and loans by demographic characteristics of applicant and borrower, and lower layer SOA. This information clearly constitutes commercial information.

The second aspect of the test relates to the level of competition in the market in question. Disclosure is less of an issue if the provider enjoys a monopoly over provision of goods or services in question. This is not the case in the UK. While there may indeed be high levels of market concentration in UK retail banking, there is no sole provider that enjoys a monopoly. Nevertheless, as the disclosure would cover all institutions rather than a single organisation, it is difficult to see that it would adversely affect one single institution.

A third aspect concerns the potential reputational impact of the disclosure on the firm or firms in question. Releasing information that may damage a firm's reputation may impact on revenue or threaten ability to obtain supplies or secure finance. In these circumstances, according to the Information Commissioner (undated), the commercial interest exemption in the Freedom of Information Act may be applied.

It is hard to envisage any impact of releasing this data on stock prices, consumer confidence or any other reputational impact that may affect the banks' revenue. The data would reveal market shares in particular areas and to particular groups, but would not reveal anything new about the overall profitability or stability of the provider. It may be embarrassing for a provider to be revealed to lend very little to deprived communities or having little market penetration in certain areas, but 'there is no exemption for embarrassment, only where there is a real risk of such harm being caused could the exemption be engaged' (Information Commissioner, undated).

The fourth part of the test concerns whether the commercial interests of other stakeholders, such as suppliers, public authorities or investors, would be affected by the disclosure. It is difficult to envisage a situation where this would happen. The data that it is proposed would be disclosed would only reveal market penetration in local communities and not any information directly related to other stakeholders, such as purchasing of inputs.

The fifth component of the test of prejudice is perhaps the most interesting as it concerns commercially sensitive data. Data classed as commercially sensitive tend to relate to the competitive edge of a firm. This may be linked to the firm's pricing structure, costing, working practices and other aspect of business that is important in explaining the competitive edge of the firm. Data on market share, which is what is proposed to be disclosed, might reveal a provider's competitive advantage, as a firm's financial position may be driven by its dominance of certain markets.

However, the question is whether the market shares of financial institutions are not already known. At the very least, the dominant market players' share of the various markets is known (see, for example, Independent Commission on Banking 2011) and with the growing sophistication of geo-demographic and geographical information systems the industry is able to perform sophisticated and detailed market segmentation (see, for example, Leyshon and Thrift 1999). It is thus questionable whether in fact such data would constitute commercially sensitive data.

The final part of the test of prejudice is about the probability of the prejudice being caused. Answering this question ultimately hinges on one's judgement. On balance, there would not seem to be a significant risk of the prejudice occurring. There seems to be limited risk of impact on other stakeholders, or impact on reputation or business confidence, and the disclosure proposed would probably not reveal the competitive edge of financial service providers.

On balance, it would be hard to argue that the level of banking disclosure demanded by proponents would constitute commercially sensitive and, therefore, commercially damaging information.

Disclosure carries risks to individual privacy

A final concern is that the banking disclosure would threaten individual privacy. In the US, researchers have been able to use a combination of variables found in the anonymous HMDA record such as loan amount, lending institution, and the geographic location of a property to create a unique variable that, when paired with public real estate records, can identify the homeowner and property address associated with a HMDA loan transaction.[18] In the UK, this would breach the data protection laws.

There are generally increasing threats to individual privacy. There is an increased sophistication of statistical tools and techniques that enable one to identify individuals from anonymised data with a certain level of confidence (see, for example, Longhurst et al. 2007). There has also been a growth of private databases (Longhurst et al. 2007), though in the UK and EU there is legislation to protect consumers from unlawful collection and use of their personal data.

The risks associated with the HMDA data do exist and it is likely that the disclosure of the same data in the UK would potentially pose challenges in terms of protecting the identity of individuals. Under a UK HMDA, the public would have access to, by mortgage provider, the number of applications and loans approved by lower layer SOA. On average a lower layer

SOA has a population of 1,500 people (around 500 households). At this level there may be several ways of identifying individuals. One could match the data with information from other sources, such as data on house sales. The risks are particularly great for cells of information with a low number of data subjects (i.e. individuals) and there would presumably be many such cells of information with this information being publicly available by the provider.

In addition, under such legislation, data would also be available on applications and loans by ethnicity, sex and race on a local authority level, and by relative income and ethnic composition of lower layer SOA on a local authority level. In small and homogeneous local authorities it may be possible to also identify individuals, especially if one has some other piece of information on the individual (e.g. due to being the person's neighbour or colleague, etc.). According to the BBA, even disclosing industry level SME deposits and lending at a level of granularity below postcode sector area would raise concerns because of the possibility of identifying individual businesses.

It is of course possible to protect, with a certain level of confidence, against the exposure of individual identities. To protect public statistics against such breaches, the Office for National Statistics applies a number of techniques prior to releasing such data[19] (Longhurst et al. 2007). It is likely that the financial institutions would also have to apply such techniques or, at the very least, assess the risk of identification of individuals if they were to disclose data along the lines of US banking disclosure. This would mean additional costs for providers.

Conclusion: The evidence only partially supports the arguments made around the risks associated with greater banking disclosure

In summary, the case against banking disclosure legislation is only partially supported by our analysis of the evidence. While the costs to the regulator are likely to be modest, the start-up costs to providers may well be considerable, especially for HMDA-type disclosure. Banks would have to redact and apply statistical techniques to protect the identity of individual customers. Although there are significant differences between the UK and the US, namely that the UK financial sector is more competitive internationally, more consolidated and less regulated, we do not believe that these differences necessarily preclude greater banking disclosure. We also do not agree that the data disclosed would constitute commercially sensitive data and we believe there are ways around privacy concerns, although it would in some cases involve reducing the granularity and usefulness of the data.

Chapter 5
Conclusions and recommendations

Introduction

In the US there has been a longstanding tradition of banks disclosing their lending and investment in deprived communities. This has been linked to a perceived obligation by banks to serve the whole community. In the UK there have been numerous calls for disclosure since the late 1990s, but to date there has been relatively little serious public debate concerning the merits of disclosure legislation. Suspecting that this may be due to a lack of consideration of its wider implications, this report carefully examined the risks and opportunities associated with such legislation.

Calls for greater banking disclosure as is current practice in the US

Banking disclosure is defined as the public disclosure by individual financial institutions of their lending and investment in defined geographical areas.

In the US, financial institutions have been required to disclose data on lending and investment since the 1970s. This includes disclosing socio-economic, demographic and loan characteristics and outcome of applications on the level of the mortgage applicant under the Home Mortgage Disclosure Act (HMDA) and on lending to small businesses and to low- and moderate-income communities under the Community Reinvestment Act (CRA).

Current practice in banking disclosure in the UK is uneven, not standardised and not broken down to specific geographical areas or individual providers. The calls for disclosure vary considerably in nature and magnitude. Some call for individual banks to disclose lending in the most deprived communities, which they already do on an industry level. Others argue for much more comprehensive geographical and customer-level disclosure along the lines of that required in the US.

The evidence only partially supports arguments made around the opportunities associated with greater banking disclosure

The case for UK banking disclosure legislation is only partially supported by our analysis of the evidence. UK banking disclosure legislation along the lines of US disclosure would on its own not be sufficient to identify or deal with practices of redlining or discrimination if these exist in the UK. This is because the data disclosed does not contain information on debt burden or credit history, which are important in determining creditworthiness. However, it is believed that disclosure could support research in the determinants of underinvestment and lending, which in turn would aid by enhancing our understanding of some of the underlying processes of financial exclusion and underinvestment. There is little evidence to support or negate the argument that banking disclosure in itself increases lending and investment in deprived communities.

The case against banking disclosure is also only partially supported by our analysis. The costs to the regulator are likely to be modest. The costs for providers to set up systems to support disclosure may well be considerable, especially for HMDA-type disclosure, though once up and running the costs are likely to be less significant. Banks would have to redact and apply statistical techniques to protect the identity of individual customers. Although there are significant differences between the UK and the US, namely that the UK financial sector is more competitive, is more consolidated and is less regulated, we do not believe that these differences necessarily preclude greater banking disclosure. We also do not agree that the data disclosed would constitute commercially sensitive data, which is one risk associated with disclosure.

We agree that the arguments used to underpin the case for greater banking disclosure – combating discrimination in financial service provision, strengthening our understanding of deprived communities and spurring greater investment in these areas – are valid policy concerns. However, based on our analysis of these arguments, we question whether greater banking disclosure is in fact the most effective means of resolving these issues. It is important to note that banking disclosure would not, in the absence of data on creditworthiness, be able to detect discrimination and redlining. Further, there is no evidence linking disclosure to greater lending and investment in deprived communities.

Notwithstanding our scepticism concerning the effectiveness of US-style banking disclosure in the UK in increasing lending to excluded communities, households and businesses, we acknowledge that there may be political arguments for introducing disclosure. In particular, there is an argument that anchors disclosure within a rights and accountability framework, within which citizens have rights to financial services and financial institutions should be held accountable for their behaviour regardless of whether disclosure is effective per se.

One could of course argue that because the effectiveness of disclosure in the US is linked to obligations to reinvest in low and moderate income communities and to enforcement through merger and expansion applications, that the UK should adopt the CRA in its entirety. We have not examined the feasibility of this and we would therefore not make this recommendation. However, enforcement through merger and expansion applications would not be effective in the UK given that there are unlikely to be many such applications in the future. Also, given that UK banks are national rather than local in nature, there are questions around how one would identify the areas in which a bank would have the obligation to reinvest.

Greater disclosure can enhance understanding of deprived communities

That said, we believe that disclosure would likely strengthen our understanding of deprived communities and the phenomenon of financial exclusion and drivers and nature of underinvestment. However, greater banking disclosure is potentially very costly for providers. This is particularly the case for HMDA. There may in particular be considerable set-up costs to facilitate the disclosure of lending and investment by geographical areas that correspond with areas for which national statistics produce data.

Hence, greater banking disclosure would have to balance the benefits and the costs. We outline three steps the banking industry could take that would constitute moderate costs and potentially great benefits.

First, the banks reporting small business lending in the 2 per cent most deprived electoral wards should, as a first step, disclose this data in their individual CSI reports. Presumably this would involve very limited costs, if any, as they already disclose the data on a consolidated basis through the BBA website. At the same time, it would indicate how well individual banks serve deprived communities.

Second, as part of its planned publication of SME deposits and lending by postcode area, we would strongly recommend that the BBA discloses the total number of applications (including failed applications). This is because the information on a proportion of failed applications would enable local and national policy-makers, researchers and other stakeholders to identify the root causes of exclusion in the area. In other words, is the low level of business lending in one area due to a high proportion of rejected applications or due to a low level of demand? These would indicate different problems and would require different types of interventions.

Third, we recommend that the BBA extends the publication of industry data on postcode area basis to include mortgage (applications and loans) and personal bank accounts (applications, accounts opened).

While it might be helpful to have this data on smaller geographical areas, the costs combined with the limited evidence for broader positive effects of disclosure suggest that this level of disclosure may be the most appropriate way forward. Combined, these three measures would enable researchers and policy-makers to better understand the nature and drivers of financial exclusion and underinvestment in areas.

Appendix I
Analytical template of risks and opportunities

The table presents the analytical template guiding the analysis of the risks and opportunities associated with the introduction of disclosure regulation. The first column lists and briefly describes the risk/opportunity, while the second details the questions that need to be answered to assess the risk/opportunity. The final column sets out the requirements and circumstances under which a risk would constitute a significant obstacle to a disclosure act. This column serves as a series of litmus tests concerning the appropriateness of disclosure regulation in the UK.

Risk/opportunity	Questions	Litmus test
Costs for financial institutions and regulators Disclosure may be too costly for regulators and financial institutions to implement and operate.	*What would be the costs of implementing disclosure for financial institutions?* Would disclosure require the collection of data additional to what they already collect (i.e. from customers)?	*What would constitute unreasonable cost implications for regulators and financial institutions?* Would costs associated with disclosure outweigh potential benefits?
	Would disclosure require investment in MIS (e.g. to be able to store and retrieve additional information)?	Would disclosure require considerable upfront investment by financial institutions in IT systems and capacity, and in changing customer forms?
	What would be the costs of implementing disclosure for regulators? Would disclosure require the collection of data additional to what they already collect (i.e. from regulated institutions)?	Would it also involve considerable staff resources for regulators and financial institutions in collating, reporting and disclosing relevant data?
		Would contributions by financial institutions towards regulation have to increase?
	What would be the costs of operating disclosure for financial institutions? What staff (and other) resources would have to be dedicated to collate the relevant data and put it into a reporting template?	*What would constitute reasonable cost implications for regulators and financial institutions?* Would potential benefits outweigh costs associated with disclosure?
	What would be the costs of operating disclosure for regulators? What are the staff and resource implications of running a website/database for disclosure of data?	Would upfront investments and staff resources associated with disclosure be modest compared with potential benefits?
	What staff (and other) resources would have to be dedicated to collate and disclose relevant data?	*How will this be established?* Through interviews with FSA and banking industry.
		Estimated disclosure costs in the US.
		Production estimates.

Risk/opportunity	*Questions*	*Litmus test*
Potential benefits of disclosure Disclosure may not lead to greater inclusion or form a base for more informed policy-making.	What are the potential benefits of disclosure? To what extent is this borne out of the empirical literature? What does the empirical evidence/literature say about the impact of disclosure on financial/social inclusion, effectiveness policy, decision-making, targeting and investment in financial inclusion? To what degree can the findings from this empirical literature be transferred to a UK context?	*What would constitute insufficient potential benefits of disclosure?* Is there little evidence that disclosure produces any tangible benefits for excluded individuals or policy-makers? Are potential benefits of disclosure found in literature not transferable to a UK context? *What would constitute meaningful potential benefits of disclosure?* Is there considerable evidence that disclosure produces tangible benefits for excluded individuals and policy-makers? Are the potential benefits tangible and transferable? *How will this be established?* Review evidence on effect of disclosure. Draw on lessons from US. Consider transferability.

Risk/opportunity	*Questions*	*Litmus test*
Coverage of non-traditional financial institutions Non-traditional financial institutions may not be covered by disclosure, constituting an unfair competitive advantage for these providers and limiting the coverage and effectiveness of disclosure.	Who are the so-called non-traditional financial institutions? What is the size and market penetration of the non-traditional financial sector? To what extent are non-traditional financial institutions covered by existing regulation?	*In what circumstances would coverage of non-traditional financial institutions be problematic?* Are non-traditional financial institutions not covered by disclosure regulation, giving them a competitive advantage via less regulation? Are non-traditional financial institutions large enough for this to be problematic? *In what circumstances would coverage of non-traditional financial institutions be unproblematic?* Are non-traditional financial institutions covered by disclosure regulation by running under existing bank's licence or directly, or they are small players making their inclusion or exclusion insignificant? *How will this be established?* Through interviews with regulators. Review literature on composition of financial sector.

Risk/opportunity	*Questions*	*Litmus test*
Coverage of foreign banks Foreign banks may not be covered by disclosure, constituting an unfair competitive advantage for these providers and limiting the coverage and effectiveness of disclosure.	What is the definition of foreign banks? What is the size and market penetration of the foreign banks? To what extent are foreign banks covered by existing regulation?	*In what circumstances would coverage of foreign banks be problematic?* Are foreign banks not covered by disclosure regulation, giving them a competitive advantage via less regulation? Are foreign financial institutions large enough for this to be problematic? *In what circumstances would coverage of foreign banks be unproblematic?* Are foreign financial institutions covered by disclosure regulation by running under existing bank's license or directly, or they are small players making their inclusion or exclusion insignificant? *How will this be established?* Through interviews with regulators. Review literature on composition of financial sector.

Risk/opportunity	*Questions*	*Litmus test*
Commercially sensitive data Disclosure may jeopardise the competitiveness of financial institutions by disclosing commercially sensitive data	What is the definition of competition and competitiveness? What is the definition of commercially sensitive data? Would data on lending to low-income households and in deprived communities constitute commercially sensitive data?	*In what circumstances would disclosure jeopardise competitiveness of financial institutions?* Does disclosure jeopardise competitiveness of and cause harm to financial institutions (reputation, ability to secure finance, etc.), revealing the source of their competitive edge (used to generate profits) and would it be advantageous to rivals? Is the disclosure of the information also not in public interest? *In what circumstances would disclosure not jeopardise competitiveness of financial institutions?* Does data disclosed not constitute commercially sensitive data as it does not reveal trade secrets, or cause harm to financial institutions, nor is it advantageous to rivals? Is disclosure in public interest? *How will this be established?* Through interviews with regulators and banking industry. Review literature on commercial sensitive data and competitiveness. Define commercially sensitive data and compare with proposed disclosure.

Risk/opportunity	*Questions*	*Litmus test*
Data protection issues Disclosure may make it possible to identify individual customers.	Would the disclosure of lending to particular groups enable people to identify individual customers (especially if data disclosed on small geographic areas)?	*In what circumstances would disclosure contravene data protection regulation?* Does disclosure of characteristics of customers at geographical level proposed enable identification of individual customers in certain areas and therefore contravene data protection regulation? *In what circumstances would disclosure be in accordance with data protection regulation?* Does the nature and level of data disclosed not enable identification of individual customers in certain areas and does it therefore not contravene data protection? *How will this be established?* Review data protection issues.

Appendix II
Voluntary disclosure by UK banks

British Bankers' Association

The British Bankers' Association (BBA) currently publishes information on lending to small businesses in deprived areas on a monthly basis. Seven banks contribute to this data: Barclays, Clydesdale (including Yorkshire Bank), HSBC, Lloyds Banking Group (including HBOS), Royal Bank of Scotland (including NatWest), Santander UK (including Alliance & Leicester) and The Co-operative Bank. Information is available from 2004–11. Although the reports specify which individual banks contribute to the data, it is not outlined how much is attributed to each bank.

On a monthly basis, the BBA publishes data and commentary on the business of the main high street banks. This covers deposits, lending to households through mortgages, overdrafts, personal loans and credit cards, and lending to all businesses in the UK, broken down by standard industry sectors. According to the BBA, the activities of the high street banks are a significant proportion of retail banking in the UK offered by all banks and building societies, so the BBA release is believed to be a good regular indicator of bank and customer behaviour across the sector. Again on a monthly basis, the BBA publishes a release covering all credit card activity for UK cardholders – focusing on spending, repayments, balances bearing interest and account usage.

Developing an historic dataset covering support for small businesses, the BBA has recently expanded the scope of this information as part of the Better Business Finance Taskforce, to produce quarterly industry datasets showing a breakdown of support for small and medium sized enterprises (deposits held, loans and overdrafts approved within industry sectors monthly and within geographical regions quarterly). On an annual basis, the BBA will shortly publish stocks of SME deposits and lending down to postcode area level (some 120 areas across England, Scotland and Wales). According to the BBA, below this level of granularity, disclosure concerns do emerge, either because of too few banks active in an area, or because of the risk of identifying businesses – after all, banks retain a confidentiality undertaking with customers and data compilers have a duty to preserve commercial sensitivities.

On a wider industry basis, the BBA produces an annual compendium of banking industry data that stretches back over 30 years in some instances. Across all of these 'outputs', the BBA aims to produce authoritative and impartial data to enable the media, market commentators and analysts, the authorities, the public and the financial services industry itself to be able to understand the contribution the banking sector makes to the economy, the services and products it provides and indications of trends, market sizes, competition and behaviour in the financial marketplace.

Barclays plc

Barclays supports voluntary disclosure and for 10 years has published data on lending activities in deprived regions of the UK. Barclays maintains that it is the only bank to do so on a 'regular and detailed basis'. Lending to small businesses in deprived areas is disclosed by Barclays, although figures are not available online pre-2002. Figures are also not available for 2010. However, in 2009 it reported a 29 per cent increase in the number of new loans made to small business customers in deprived areas and that 2.5 per cent of small business customers with Barclays were based in the most deprived areas in the UK.

Currently Barclays does not disclose the value of specific reinvestment in deprived communities. It does disclose total community investment in the UK from 2007 onwards (last figures are for 2009)[20] but this is not broken down further by postcode or even region. Reports are published regarding social responsibility and citizenship but these do not remain of constant format or even title. The reporting data, layout and titles of the reports change and so even year by year they are not comparable. For example, the reports are included in a corporate responsibility report from 2002 to 2006, in a sustainability review for 2007 and 2008, in a responsible banking review in 2009 and in a citizenship report in 2010.

In some reports the information goes into specific details (2006 *Corporate Responsibility Report* – '85% of our funding for local community finance organisations in the UK was focused in the most deprived areas') but overall it appears that the bank is disclosing less detail in later years than previously.

The actual definition of deprived changes over time and from report to report. On several occasions 'deprived' means the top 5 per cent most deprived postcodes in the UK (however, it is not specified where this data is gathered). On another occasion, in another report, 'deprived' means areas identified by the Bank of England in its report *Finance for Small Businesses in Deprived Communities*, published November 2000. There is no consistency from year to year on the definition and it is often not clarified within the report.

Barclays does provide some facts and figures on reinvestment but there are no footnotes explaining these further or providing any basis for the claims. Below are facts and figures on reinvestment into deprived communities and financial inclusion in the UK:

- The basic cash card account has more than one million customers, of which approximately 87,000 live in deprived areas of the UK.
- The Barclaycard Horizons programme, in partnership with Citizens Advice Bureau, Family Action and Gingerbread, supports lone parents and their children through a programme of debt advice, financial literacy training and grants for education. Since 2005, Barclaycard has invested more than £7m in the Horizons programme and in 2010 reached more than 130,000 lone parents and their children.

- It has a partnership with Action for Children that addresses financial exclusion and improving financial capability to improve the life chances of young people.
- In the UK, Barclays Money Skills is its flagship financial capability programme, an investment of £15m. By the end of 2011, Barclays aims to have helped more than 300,000 people improve their financial capability over the year.
- Since 2004, Barclays has provided over £3m to community finance in the UK, supporting more than 100 credit unions and CDFIs. It will provide £1m to support the Barclays Community Finance Fund, in which credit unions and CDFIs will be able to apply for funding of up to £50,000.

In the recent 2011 *Citizenship Report* Barclays states that the number of basic cash card accounts held with the bank has increased from 1,017,494 to 1,196,286 and that Barclays remains the only high street bank to allow undischarged bankrupts to open an account. It does not, however, advise how many customers of its basic bank account live in deprived areas although this information was provided for 2010.

Royal Bank of Scotland

Information on lending to small businesses in deprived areas and community reinvestment is published by the RBS Group, although the detail is somewhat limited. For example, current information on lending to SMEs in deprived areas is vague:

> We have been committed to supporting enterprises with a social purpose for many years. We work with partners to create opportunities for businesses that may not have traditionally had access to financial services. In doing this, we hope to enable social innovation and make a difference in the communities that we operate in.[21]

However, some specific detail can be found in previous sustainability reports:

- In 2010 the RBS Group had a leading market share in third sector businesses and lent £525 million in term loans and £57 million in overdrafts to businesses in the 5 per cent most deprived electoral wards in the UK.
- In 2009 the group increased lending in the UK's 5 per cent most deprived electoral wards, giving it a 33 per cent market share.
- In 2008 the group's lending in the 5 per cent most deprived wards in the UK increased, giving it a 34 per cent market share.
- In 2007 it demonstrated a particular commitment to supporting small business in poorer areas and is the lead banker to SMEs in the 5 per cent most deprived wards in the UK. In 2007, the group lent £517 million.

Some information is already disclosed as Citizens Bank is part of the RBS Group and is based in the US. Data on lending and reinvestment within this branch of the company is disclosed as part of the US CRA.

As stated, the RBS Group tends to concentrate on publishing details of its funding of community programmes and financial capability through Moneysense, stating, 'In 2010, we invested £56.2 million in communities through these programmes.' The group has also launched its 'Customer Charter' recently with the introduction of a UK Community Fund, which sets aside funds in order for local people to decide where it should be invested. In 2010 it donated £1.6 million to 977 local community organisations across the UK.

Information on reinvestment is not included in annual reports, but instead is published in specific 'sustainability' reports. Even here, disclosure information then only consists of several lines of text in no great detail.

HSBC

HSBC does not disclose any information on lending to SMEs or reinvestment in deprived communities in the UK.

Santander

Santander does not specifically disclose information on reinvestment and lending to deprived areas in the UK. Rather, it advises in its 2010 sustainability report that 'the bank creates products and services linked specifically to its commitment to the most vulnerable groups and to sustainable development'. However, further specific detail is not provided.

The bank acknowledges that the UK provides its largest customer base, with 26.6 per cent of worldwide custom, but it provides no specific UK-wide information on reinvestment and lending to deprived communities. However, the group does provide information on funding financial education, as in 2010 it launched 'Santander in Schools', 'My Money, My Rights' and the 'Student Money Manual in the UK', through which young people can learn about basic concepts such as the importance of savings, investments and access to loans and credit. Finally, the Santander Foundation is a UK-based grant-giving fund that assists charities and education projects to work in disadvantaged areas.

Lloyds Banking Group

Lloyds discloses information about lending to SMEs within deprived communities, and also the level of reinvestment and grant funding generally. Its 2010 *Responsible Business Report* and 2009 *Corporate Responsibility Report* state, 'We are committed to providing support to the businesses in every area of Britain, including in deprived areas. We track and publish our lending to small businesses in deprived areas.' This is followed up as it discloses that it lent £364 million to businesses in the top 5 per cent deprived areas; that it has 28,000 small business customers in deprived areas across the UK; and that it lends more money to businesses in deprived areas than the industry average. It asserts that 4.1 per cent of its lending is to small businesses in deprived areas, whereas the industry average is 3.9 per cent (June 2008–09).

In previous years' reports, Lloyds also set out explicitly the level of reinvestment and lending to small businesses in the UK. In its 2008 *Corporate Responsibility Report* it states that it lent £315million across the top 5 per cent areas of deprivation (June 2007–08) and that it committed around £18 million to the community finance sector, in addition to commercial lending direct to small businesses.

In personal banking, statistically, the bank decreased between 2008 and 2009 with regards to the amount of basic bank accounts held, though this is not explicit within the reporting data. In 2008 it had 4 million social banking accounts; in 2009 it had 3.85 million. In 2010 this has risen to 4.2 million.

In 2010 specifically, it opened 260,000 new basic bank accounts, representing a 32 per cent share of all new basic bank accounts. In 2009 the group reported that 8.2 per cent of its social banking customers (10 per cent in England) lived in the 5 per cent most deprived areas in the UK and that, in total, 1.27 million of its bank account holders lived in deprived areas. Table II.1 lists information dated December 2010.

In terms of community reinvestment, Lloyds asserts it is the biggest investor in UK communities, and invested £76 million in 2010 into grassroots charities, financial inclusion

Table II.1
Basic bank accounts, and number in deprived areas, at Lloyds Banking Group, December 2010.

	No. basic bank accounts	*No. basic accounts in deprived areas**
2010		
England	3,645,711	361,624
Wales	233,385	17,394
Scotland	355,671	8,705
Northern Ireland	1,490	0
Not stated**	9,232	0
Total	4,245,489	387,723
2009		
England	2,999,998	294,458
Wales	148,748	10,530
Scotland	601,369	11,827
Northern Ireland	65,552	N/A
Not stated**	41,861	N/A
Total	3,857,528	316,815

Notes
* One of the reviewers consulted believed that these figures were implausible.
** For some accounts, particularly those opened some years ago, customers were not required in the application process to state which of the home nations they live in.

and capability and sports for young people. Finally, it holds the Business in the Community's 'CommunityMark' – the national standard that publicly recognises excellence in community investment.

Building Societies Association

Information on general community giving and investment is published throughout various reports published by the Building Societies Association, but this detail is vague at best and does not break down either by building society or community, making it of very limited use. There seems to be a general assumption that building societies are more charitable than banks.

The report *Building Societies at the Heart of their Communities* (2009) states that building societies are more involved within their local community and that many have written charitable policies that ensure only projects within their specific locality get funding. These projects cover arts/culture, sport, health, education and environmental causes.

British Association of Insurers

There is no disclosure of information on availability and take-up of insurance by area either by individuals or businesses. This information may be available through the member zone but requires subscription. However, it does acknowledge that access to insurance for those in socially deprived areas is an issue and is under government focus. Accordingly, via the Association of British Insurers, the industry has set up an Access to Insurance Working Group. The working group will initially assess social tenants' access to contents insurance and will move to other issues later. There is no information, however, on the progress of the working group or when the information was last updated.

Appendix III
The financial sector in the US and UK

US financial institutions

The financial services needs of American consumers are served by a wide array of institutions. These institutions range from large commercial banks that provide a diverse set of products and services to consumers and businesses to niche or 'fringe' financial services providers that offer more specialised products to narrow markets, often at high costs. Recent trends within the industry have led to polarisation between the largest and smallest banks, with the largest players gaining market share and becoming increasingly complex and smaller community banks focusing their activities on more traditional bank products targeted to their local markets. The following section will briefly describe the composition of the financial services industry in the United States.

Depository financial institutions

Depository financial institutions make up the largest segment of the financial services industry in the United States. There are a number of different types of depositories, such as commercial banks, thrifts, and credit unions. Although these entities differ in many ways (such as corporate structure, sources of capital, and regulatory oversight), they typically offer similar types of products and services. The traditional role of these institutions is to take deposits from consumers and businesses, process credit transactions, and provide loans for purposes such as home mortgages and small business development. These institutions deliver their products and services through a diverse set of channels such as brick and mortar branches, limited service branches often located in other types of retail establishments such as supermarkets, automated teller machines (ATMs), and the Internet. They are regulated by federal and, sometimes, state agencies for the safety and soundness of their business operations and their compliance with consumer protection regulations. The Federal Deposit Insurance Corporation (FDIC) is a government corporation created after the Great Depression that guarantees the safety of deposits in member banks, currently up to $250,000 per depositor per bank.[22]

The banking industry in the United States has gone through dramatic growth, consolidation, and restructuring in recent decades. From 1992 to 2010, the number of institutions insured by the FDIC fell from nearly 14,000 to around 7,600, but the assets insured increased from US$4.5 trillion to US$13.3 trillion.[23] As this growth and consolidation occurred, a growing share of banking assets became concentrated in the largest institutions. Between 1992 and 2010, the assets controlled by FDIC-insured institutions with over US$1 billion in assets increased by over 237 per cent, and these large institutions went from controlling 69.2 per cent of FDIC-insured assets to controlling 89.2 per cent of these assets.

These changes in the structure of the industry were triggered both by federal regulatory reforms that facilitated bank mergers and by changes in the industry. In the 1990s, the US Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act (1994) and the Gramm-Leach-Bliley Act (1999), which together removed restrictions that prevented banks from merging with institutions from other states and prevented commercial banks from merging with or acquiring firms offering other types of financial products such as securities or insurance (Wilmarth 2002). This deregulation around mergers and acquisitions allowed financial institutions to consolidate and create increasingly large and complex financial holding companies. These institutions gained increased access to new sources of low-cost capital which, when combined with advances in technology, gave large banks economies of scale that allowed them to deliver products and services to a larger pool of customers more efficiently and at lower costs than many smaller banks (Wilmarth 2002).

The trend towards consolidation in the US banking industry was accelerated in 2008 by the US banking crisis. The industry entered a crisis following the collapse of the US housing market and subsequent collapse of the commercial real estate market. Many banks that had invested heavily in risky mortgage loans and real estate transactions were bailed out by the US government, while many other banks failed outright and their assets were acquired by other institutions. Between 2008 and 2010, 335 banks failed with their assets frequently acquired by larger financial institutions that had been stabilized by the federal government[24] (see also Brown 2008).

In the wake of this crisis, the structure of the US banking industry remains polarised. At the top of the industry are large international banks such as Bank of America, JP Morgan Chase, and Citigroup that offer a wide range of products to a broad market of consumers nationally. These banks benefited from being stabilised by the federal bank bailout, and many have recently returned to profitability despite ongoing concerns about bad loans in their portfolios (see for example Popper 2011). Mid and small sized regional and community banks often continue to struggle. Smaller banks benefited less from the bailout and, for many banks, their loan portfolios remain burdened with underperforming commercial real estate assets. In many cases, these banks are limited to managing troubled assets and have a reduced ability to make new loans. This has increasingly made many mid sized and smaller banks targets for takeover by larger institutions or international banks (see for example Pasternak and Alexander 2011).

Non-depository financial services providers

While the mainstream banking industry serves the broad financial services needs of many consumers, it has often been less successful at serving the needs of customers in lower income urban and rural communities and communities of colour. For example, minority households in the US that are more likely to be unbanked than white households include blacks (an estimated 21.7 per cent of black households are unbanked), Hispanics (19.3 per cent), and American Indian/Alaskans (15.6 per cent). As a result, a host of non-depository financial services providers that specialise in serving lower income communities has developed in recent years. While some of these firms, such as community development finance institutions (CDFIs), work to fill gaps in access to capital and credit in these markets in a responsible manner, many other types of firms take advantage of a lack of access to mainstream financial products in these neighbourhoods. Firms such as payday lenders and cheque cashers often function with little or no regulatory oversight and offer higher cost products that many advocates and policy-makers feel are abusive, strip wealth from, and impede economic opportunity, in lower wealth communities.

As urban areas transformed in the United States in the 1960s and 1970s, many city neighbourhoods went through substantial demographic and economic shifts. Many communities saw white populations leave central cities as African Americans increasingly moved from rural communities to urban neighbourhoods. At the same time as this 'white flight' was occurring, many banks that were based in these neighbourhoods stopped making loans to these communities and frequently closed branches. The policy response to this redlining will be discussed later but, in many cases, the void in access to financial services such as basic cheque and savings accounts and loans created by the flight of banks from these communities has never adequately been filled by mainstream institutions (for a discussion of the history of redlining see Immergluck 2004).

Over the years, however, an array of largely non-depository financial services providers emerged to fill this void by providing services to these communities at typically higher costs and often abusive terms. The most prominent recent example of such an institution is subprime mortgage lenders who specialised in extending credit to borrowers who could not access conventional mortgages through mainstream financial institutions. Subprime lenders were largely non-bank mortgage companies that made loans to borrowers with weak credit histories and limited downpayments in exchange for higher interest rates and fees to compensate for the additional risk being taken on by the lender.

These loans were typically originated through third-party mortgage brokers as opposed to brick-and-mortar offices. While representatives of the lending industry argued that subprime mortgages expanded access to credit to previously underserved markets, many advocates and policy-makers argued that subprime lenders charged excessive interest rates and fees and structured loans in such a way as to make them unaffordable almost immediately after origination and that these loans were targeted to communities of colour (Schwemm and Taran 2010). Advocates also argued that mortgage brokers had financial incentives to steer borrowers into loans with high interest rates or less advantageous features such as prepayment penalties because they generated higher broker fees (Ernst et al. 2008).

There are a number of other types of non-depository financial services companies that provide services and loans to consumers outside the traditional banking industry, including currency exchanges, payday lenders, and tax refund anticipation loan providers. Currency exchanges cash cheques for higher fees than a customer would pay at a bank or through direct deposit. Payday lenders provide short-term, small dollar consumer loans, but frequently charge fees well in excess of what one would pay for similar amounts of credit offered through a small bank loan or credit card. Payday loans also frequently have features that can trap borrowers in cycles of escalating debt. Tax refund anticipation loans (RALs) are high-cost cash advances on an individual's federal income tax refund. RALs are low-risk transactions for lenders because they are secured by an individual's tax refund, but they carry high fees relative to this risk. These fees have been a concern for policy-makers because RALs are most often used by lower wealth households and in communities of colour, and the fees charged reduce the economic benefits of tax credits that are provided to low-wage workers and families (Duda et al. 2010).

While these non-depository financial services providers often fill gaps by providing higher cost loans and services to customers that banks are not adequately serving, mainstream banks frequently have close and profitable relationships with these non-depository firms. In the case of subprime lending, many large bank holding companies operated large subprime lending affiliates separate from their depository entity. For example, Washington Mutual was a large thrift institution[25] that also operated Long Beach Mortgage, a large subprime, non-depository lender. With other types of products, banks provide high-cost services through third parties. For example, banks offer federal tax refund anticipation loans through tax preparation firms as part of their tax preparation services. For many years, banks such as JP Morgan Chase and HSBC were some of the nation's largest tax refund anticipation loan providers.

The UK financial sector

The UK financial sector is of great importance to the UK economy. Total banking assets are 5.5 times GDP, which is higher than in the Euro area and much higher than in the US (Davis 2009). Half a million people are employed in the banking sector and a further half a million in the financial sector overall (Davis 2009). Since the early 1990s and up until the financial crisis, the UK banking sector has undergone a long period of growth in profitability (Davis 2009). This is, as will be discussed further down, of great importance in understanding the regulation of the sector.

The sector is dominated by a handful of financial institutions. The four largest banks' total market share fell from 74 per cent in 2000 to 64 per cent in 2008, but increased again to 77 per cent in 2010 largely due to the Lloyds TSB/HBOS merger (Independent Commission on Banking 2011). The greatest market concentration can be found for SME banking (turnover up to £1 million), personal current accounts and personal loans, while there is less concentration in personal mortgages, personal savings and personal credit cards (Independent Commission on Banking 2011). The Independent Commission on Banking (2011) noted that competition in the sector was further underpinned by very low switching rates.

The consolidated nature of the sector can be traced back to the wave of mergers and acquisitions from the 1860s to the 1910s, which culminated with the dominance of five large clearing banks by 1918. In 1920 these five banks accounted for 80 per cent of English bank deposits (Collins 1988). From the 1860s to the 1940s, governments accepted the emergence of oligopoly in the banking sector. It was only in 1968 when Lloyds and Barclays Bank announced their intention to merge and subsequently take over Martins Bank that the government put a stop to mergers in the sector.

In contrast, US governments resisted the emergence of oligopolistic banking markets through low entry requirements and putting in place barriers to cross-state banks. Consequently the number of banks grew from less than 12,000 in 1899 to more than 30,000 in 1922 (Ferguson 2009). While today the US banking sector is more concentrated than it was then, it is still much less consolidated than the UK.

There are two main reasons for this difference. First, US governments were fearful – in light of the close links between industry and banking – that unchecked mergers would lead to a concentration of power (Schweikart 1997). In the UK, there were fewer links between banks and industry and thus less fear of the emergence of actors dominating finance (Moran 1986). Second, a string of widespread bank failures in England from 1825 to 1878 made legislators push for larger banks. Financial stability rather than competition has since been a defining feature of the financial sector and its supervision and regulation.

Another defining feature of the UK financial sector is its de-compartmentalised nature. This is a relatively recent development, as up until the 1980s the financial sector was highly compartmentalised. Banks, or more specifically the London clearing banks, operated with a near-monopoly on transaction services and personal loans. This near-monopoly had its roots in the banks' co-ownership of the clearing house and the lack of alternative money transmission services. There was up until 1986 a legal requirement that building societies and savings banks should only offer term accounts requiring notice of withdrawal and not current accounts or cheques (Collins 1988). Similarly, the building societies dominated the mortgage market.

In the 1980s the functional compartmentalisation of the financial services market started to be broken down as a result of de-regulation. The abolition of restrictions on interest-bearing eligible liabilities, more commonly known as the 'corset', in the 1980s enabled banks to move into the mortgage market (Gentle 1993). Banks rapidly gained a considerable market share forcing building societies to offer market interest for savings and mortgages to attract funding (Gentle 1993), leading to a considerable decrease in the margin between deposit and lending rates (Drake 1989, cf. Gentle 1993). The 1986 Building Society Act allowed building societies to offer current accounts and unsecured lending, in addition to enabling societies to access wholesale markets and convert into public limited companies. The removal of legal and capacity-related barriers to entering certain markets led to increased competition.

Banks and building societies

The main actors in the market are banks and building societies. As noted, the UK banking sector is highly consolidated, which has been reinforced by a recent wave of mergers and nationalisations. In March 2011 banks held 68.5 per cent share of the mortgage market[26] and £760,508 million of household savings, 69 per cent of market share.[27] Six banks – Santander UK, Barclays, HSBC Bank, Lloyds Banking Group, Northern Rock and RBS Group – have two-thirds of market share of all outstanding mortgages.[28] They also provide 50 per cent of all consumer credit and 60 per cent of all new card credit in the UK. The largest four banks, Lloyds Banking Group, Barclays Bank, HSBC Bank and RBS, are particularly dominant. In 2010 these banks accounted for 85 per cent of business current accounts, 75 per cent of personal loans and 77 per cent of personal current accounts (Independent Commission on

Banking 2011). The trade body for the UK financial sector is the British Bankers' Association (BBA), which has 200 member banks from 60 countries.

Building societies are mutual organisations owned by their members, offer mainstream financial services and are traditionally seen as mortgage providers. There are 48 building societies in the UK with 2.7 million borrowers, employing approximately 43,000 staff in 1,700 branches.[29] Building societies belong to the trade body Building Societies Association. In total, building societies currently have £210 billion in mortgage lending; 17 per cent of all outstanding mortgages in the UK. In 2010, total mortgage lending by building societies was £20,439 million[30] and they took a 16 per cent share of the mortgage market.[31] From January to March 2011 building societies took a 15.9 per cent share of mortgage market, a slight reduction on the previous year.[32] From January to March 2011, building societies across the UK held £240,437 million in household savings, a 22 per cent share of market.[33]

Many banks now have Internet-only subsidiaries with no branch banking. These usually offer the same mainstream financial products – such as savings and credit cards – and often offer a higher rate of interest due to lower running costs. Egg (a subsidiary of Citigroup) is the world's largest Internet only bank and other notable examples include ING Direct (ING Group), Cahoot (Santander), First Direct (HSBC) and Smile (Co-operative Group). The percentage of clients banking with Internet-only brands is low and consistent, and customers view these channels as a complement to rather than a substitute for branch-based banking (Independent Commission on Banking 2011).

Non-bank firms

An increasing number of non-bank firms offer retail banking services, including supermarkets such as Tesco, Sainsbury and Marks & Spencer. However, the vast majority of these providers offer services via a separate subsidiary or via an established bank, both subject to FSA regulation. Hence, it is debatable whether these firms are indeed genuine non-banks (Heffernan 2006). The supermarkets listed above are offering financial services under the banking licences of the RBS Group (Tesco), Lloyds TSB (Sainsbury) and the HSBC Group (Marks & Spencer).

Credit unions and CDFIs

Credit unions and community development finance institutions (CDFIs) are relatively minor actors in the financial market, targeting primarily low-income households. In 2009 there were 453 credit unions in the UK with 788,000 members. They hold around £560 million in savings and have a loan portfolio of £464 million.[34] A minority of larger credit unions are now also offering current accounts. In 1979 the Credit Union Act was passed, which introduced a legal structure for credit unions in the UK. Credit unions have been regulated by the FSA since July 2002. The trade body for Credit Unions is the Association of British Credit Unions Ltd (ABCUL).

Members own the credit union and one of its aims is to improve the financial health of its members. A dividend is paid yearly and a board of directors sets interest rates. The credit union offers similar services to banks – such as savings accounts, credit cards and loans of up to £3,000. CDFIs assist clients who have been turned down for credit by mainstream providers. Small, independent organisations, they are often located in disadvantaged communities, with only 75 branches across the UK. Larger CDFIs are registered by the FSA and their trade body is the CDFA. In 2009/10 CDFIs in the UK lent £200 million[35] and have a loan portfolio of £531 million (March 2010).

Subprime sector

The subprime sector is diverse, comprising home credit companies, licensed financial companies, sell-and-buy-back stores, pawnbrokers and instalment credit stores. The sector offers a wide and expanding range of financial products, including credit cards, unsecured personal loans and mortgages and pre-pay cards. The subprime sector principally caters for credit-impaired and higher risk borrowers who fail to qualify for loans or other products with mainstream financial institutions. The sector offsets this greater risk by charging higher interest rates and fees relative to the mainstream sector.

There are various estimates of the size of the sector. Ellis et al. (2006) estimate that there are around 2.3 million users of high-cost licensed home credit lenders in the UK, equivalent to around 6 per cent of the adult population. A review of the high-cost credit sector by the Office of Fair Trading (OFT) found that in 2008 the sector made loans to customers totalling £7.5 billion (Office of Fair Trading 2010a).

A recent study of payday lending[36] estimated that around 1.2 million adults in the UK took out payday loans in 2009 (Burton 2010). The total lending of the payday loan sector was £1.2 billion and the industry's gross income was around £242 million in the same year (Burton 2010). In their study of UK pawnbrokers, Collard and Hayes (2010) estimated that the number of outlets had increased from 800 in 2003 to around 1,300 today, though much of this expansion has been fuelled by non-pawnbroking products, such as cheque cashing and payday loans. The sector has a loan book of around £192 million (Collard and Hayes 2010).

Appendix IV
Financial sector regulation in the US and UK

US financial sector governance

In the United States, financial institutions can be regulated at both federal and state levels. The scope of regulation includes policies covering the extension of credit and bank operations, the direct supervision and monitoring of institutional safety and soundness, and compliance with consumer protection regulations and community reinvestment obligations. This dual system of federal and state regulation can be complicated and create competition and tension between federal and state regulators. While individual states may have data disclosure laws, the primary data disclosure laws are federal and are largely implemented and enforced by federal regulators. The following section briefly describes the structure of bank regulation in the US.

Depository institutions have federal or state regulators as primary

Depository institutions such as banks and thrifts have the option of being chartered nationally or at the state level. A national bank or thrift charter gives an institution an increased ability to provide services nationwide without having to comply with diverse state-level banking regulations. A national bank charter also comes with higher supervisory costs, however, so many smaller, locally oriented banks choose a state charter to reduce these costs.

For depository institutions, the choice of a charter determines who their primary regulatory agency will be. For nationally chartered banks, the primary regulator is the Office of the Comptroller of the Currency (OCC), a division of the Department of the Treasury. For state chartered banks, oversight is shared between the respective state banking agencies and either the Federal Deposit Insurance Corporation (FDIC) or one of the twelve regional Federal Reserve banks. These regulators monitor an institution for the safety and soundness of its business operations and its compliance with various federal and state consumer protection regulations. Federal agencies also monitor bank compliance with the Community Reinvestment Act.

Non-depository institutions have state regulators as primary

Non-depository financial services providers are almost always licensed and regulated at the state level. These types of institutions include non-bank mortgage companies, mortgage brokers, payday lenders, and currency exchanges. The nature and rigour of regulation can vary dramatically from state to state. Some states issue licences allowing an institution to conduct business, but place limited restrictions on the type of business practices or products that can be offered. Other states highly regulate or restrict business practices or products for certain types of lenders. For example, states such as New York and Georgia ban high-cost payday lending entirely, while other states place no regulation on the industry at all.

Non-depository financial institutions are not exempt from federal oversight and must comply with certain federal regulations relating to the extension of credit. For example, state-regulated mortgage companies must comply with data disclosure requirements under the federal Home Mortgage Disclosure Act. Other than mortgage lenders, however, non-depository financial services providers are not currently subject to any substantive federal data disclosure requirements.

Federal agency rule writing

At the federal level, policy development is handled by a group of agencies based in Washington, DC. The Board of Governors of the Federal Reserve has significant responsibilities related to policy development and the regulation of bank holding companies. The Board is headed by the Chairman of the Federal Reserve and is charged with issuing and updating regulations that implement federal laws governing the extension of consumer credit and bank regulation.

In most cases, the Board of Governors is the primary rule-making entity for these regulations but, in some cases where the Federal Reserve shares oversight, it acts jointly with other agencies to issue regulations. For example, until recently the Board of Governors was the primary entity in charge of developing and updating the regulations implementing the Home Mortgage Disclosure Act (HMDA), but the Board of Governors shared Community Reinvestment Act (CRA) regulation responsibilities with other bank regulators, the OCC and FDIC. The Dodd-Frank Act transferred authority for HMDA rules to the new Consumer Financial Protection Bureau.

The Federal Reserve Board of Governors also has oversight over bank holding companies. In this role, the Federal Reserve Board makes decisions around mergers and acquisitions of holding companies and supervises the operations of these entities. The OCC also has rulemaking responsibilities for regulations focused on the operations of nationally chartered banks.

Federal pre-emption issues

In recent years a growing tension has emerged between policy-makers at the state and federal levels around the authority to regulate specific practices. Beginning in the late 1990s, state agencies were among the first entities to detect abusive lending mortgage practices and attempt to pass laws to protect consumers. Since then, over 30 other states passed some type of law regulating higher cost mortgage lending. Many financial holding companies that include nationally chartered banks have turned to regulatory loopholes to avoid compliance with various state lending laws, believing that a national charter gives them the ability to pre-empt state lending laws.

In 2004, the OCC released a regulatory order confirming that national banks and their direct operating subsidiaries, including mortgage companies, were not required to comply with state laws. This OCC action increased tensions between state and federal regulatory agencies as the OCC acted aggressively to protect its power to pre-empt state law. For example, in 2005, the OCC sued the State of New York to prevent the State Attorney General's Office from investigating nationally chartered banks and their affiliates for abusive lending practices. Ultimately the US Supreme Court upheld the OCC's power to pre-empt state laws as applied to nationally chartered banks.

The regulation of the UK financial sector

The principal regulator of the UK financial sector is the Financial Services Authority (FSA). Another important regulator is the Office of Fair Trading, which is responsible for issuing, monitoring and enforcing consumer credit licences. This is discussed in greater detail below.

The FSA is an independent non-governmental body granted statutory powers by the Financial Services Markets Act (FSMA) 2000. The FSA is a private company financed by the levies paid by the firms it supervises. It was created through a merger of a number of self-regulatory organisations, the banking supervision part of the Bank of England and the Register of Friendly Societies Commission. Further, in 2000 it subsumed the Building Societies Commission and the UK listings authority, and it took over regulation of credit unions in 2002. In 2004, mortgages also came under FSA regulation.

Under the FSMA the FSA has to fulfil four statutory obligations: maintain confidence in the UK financial system; contribute to the protection and enhancement of the stability of the financial system; secure an appropriate degree of protection for consumers; and reduce the degree to which it is possible for regulatory business to be used for purposes connected with financial crime.

In addition to the FSMA 2000, there is also the (Regulated Activities) Order 2001 (RAO), which specifies the activities for which firms must seek permission from the FSA to conduct. Any firm or individual carrying out regulated activity must be authorised unless they are exempt. The FSA sets criteria for licensing banks and can reject applications for licence or withdraw an existing licence (Heffernan 2006). Under the FSMA 2000, firms that want to receive deposits must by authorised by the FSA (or exempt). This is commonly referred to as a banking licence. The FSA takes into consideration five threshold conditions when considering banking licence:

- legal status of applicant (body corporate or partnership);
- location of applicant's registered and head offices (should be in UK);
- whether applicant has close links with any person or company that might prevent the FSA from carrying out effective supervision of applicant if authorised;
- whether applicant has sufficient resources (financial, human and physical);

- applicant's suitability (assessment persons connected to applicant, whether applicant will conduct business with integrity and in compliance with proper standards, and whether management is prudent and competent).

In carrying out its duties, the FSA must take the principles of good regulation into account. These are related to making the most efficient and economic use of resources, and balancing the burdens and benefits of new regulation. However, there is one principle that is telling for the UK's approach to regulating the financial sector. It states that the FSA must take into account the international character of the industry and the desire to maintain its competitive sector.

The importance of the financial sector to the UK economy may in part explain why the UK currently has one of the most liberal regulatory frameworks in the Western world. The financial sector has been a key driver of economic growth in the UK over the last 20 years. Between 1987 and 2007 the financial sector grew by 4.5 per cent per year compared to 2.6 per cent for the economy per year (Weale 2009). Indeed, without the higher growth for the financial sector, the growth of the UK economy would have been 0.2 per cent less per year (Weale 2009).

The framework under which the FSA operates is called ARROW II, which stands for Advanced, Risk-Responsive Operating Framework. Under this framework the FSA engages in both vertical and horizontal supervision and work. The former refers to assessing risks in individual firms (also called the firms approach), while the latter refers to assessing cross-cutting risks (themes approach).

The FSA applies a risk-based rather than competition-based approach to regulation, which is referred to as a Risk to our Objectives (RTO) approach. This is because the sector is thought to be so important that they must prioritise risk management. Specifically the FSA supervises firms according to the risk they represent to the statutory objectives. This is determined by assessing the scale of the effect on consumers and markets if it were to happen (impact) and by the likelihood of it happening (probability). The firms are assigned impact and probability scores on which basis the level and nature of supervision is determined.

Firms with medium and high scores will have a designated relationship manager who conducts regular risk assessments, monitors compliance and makes regular visits to meet management and test control functions. Conversely, firms with low scores do not have a fixed supervisory scheme. They are usually asked to send regulatory returns twice a year and the collective risk they pose is monitored by the regulator. High-impact groups include major banks and insurance companies, big broker-dealers, stock exchanges and large financial advice networks (Heffernan 2006).

The Bank of England is another key regulator. The Bank, as it is known, was founded as a corporate body by the Royal Charter under the Bank of England Act 1694. It was nationalised in 1946 and gained independence in 1997. The Bank is the central bank of the UK, with responsibility for promoting and maintaining monetary and financial stability. It promotes monetary stability primarily through setting interest rates. The decisions regarding the interest rate are made by the Monetary Policy Committee, which decides the interest rate necessary to meet overall inflation targets set annually by the Chancellor of the Exchequer.

In order to promote financial stability, the Bank acts as a lender of last resort and it injects liquidity to shore up markets. It detects threats to the financial system through surveillance and intelligence. The Bank shares responsibility for financial stability together with the Treasury and the FSA. While the Bank is responsible for the stability of the financial system as a whole, the FSA is responsible for the supervision of individual banks and firms. This co-responsibility was formalised in 1997 in a Memorandum of Understanding between the FSA, the Treasury and the Bank.

The OFT is responsible for regulating secured (excluding the majority of residential mortgages) and unsecured consumer lending. The OFT licenses consumer credit businesses and monitors licensed businesses. The regulatory regime for consumer credit is mainly concerned with the protection of consumers rather than the regulation of products (Office of Fair Trading 2010b). The OFT issues guidance for standards required of licensed firms in terms of responsible lending and debt collection.

Proposed changes to financial sector regulation

The recent financial crisis, which constituted 'the largest [banking crisis] since 1929–33' (Barrell and Davis 2008: 5), has led the Government to review and reform the regulation of the financial sector. In his report to Parliament, the Financial Secretary to the Treasury identified three main problems with the current system of regulation of the financial sector (HM Treasury 2011). First, the Bank of England has lacked the tools to deliver on its statutory responsibility for promoting the financial stability of the financial system. Second, the FSA had too many objectives and as a consequence the agency was not sufficiently focused on stability issues. Third, no one body has had responsibility for linking firm-level and systemic stability issues.

In response to this, the Government has proposed the following reform to the financial system. A committee called the Financial Policy Committee (FPC) will be set up under the Bank of England with responsibility for regulation of stability and resilience of the financial system as a whole. This committee will identify, monitor and remove or mitigate system risks, especially those related to unsustainable levels of leverage, debt or credit growth, and those attributable to structural aspects of financial markets and to the distribution of risks. The FPC will publish a financial stability report twice a year containing its analysis of risks to financial stability and outlining the actions it has taken to counter these risks. The committee will be responsible for macro-level prudential regulation, though the exact macro-level tools are subject to ongoing discussions (HM Treasury 2011). An interim FPC was created in February 2011, to undertake statutory macro-prudential role of FPC as well as preparatory work and analysis into macro-prudential tools.

A new agency called the Prudential Regulation Authority (PRA) will be established to conduct prudential regulation at a firm level. The PRA will be an operationally independent subsidiary of the Bank. Prudential regulation refers to the regulation and supervision of deposit-taking institutions, limiting their risk-taking in order to ensure the safety of depositors' funds and the stability of the financial system.

PRA will be responsible for regulation and supervision of all deposit-taking firms and those that issue insurance contracts, which means that it will supervise all banks, building societies, credit unions and insurers. However, it will not be responsible for conduct of business and consumer protection, as this will be the preserve of the Financial Conduct Authority (FCA). PRA will focus on the soundness of firms and stability of the financial system.

The strategic objective of the FCA will be to protect and enhance the confidence in the UK financial system. It also has to work to three operational objectives:

- facilitate efficiency and choice in the market for financial services;
- secure an appropriate degree of protection for consumers;
- protect and enhance the integrity of the financial system.

A significant new component is that the FCA must also seek to promote competition as far as it does not contradict its strategic and operational objectives. It is also claimed that the FCA will put greater emphasis on consumer outcomes rather than purely focusing on sales processes to ensure customers were treated fairly and were given sufficient information (HM Treasury 2011). Indeed, in his report to Parliament, the Financial Secretary to the Treasury states that:

> The FCA will have greater willingness to intervene in the early stages of the produce life-cycle where appropriate to deliver better outcomes for retail customers … . It is in this sense – that of putting appropriate consumer outcomes at the centre of the regulatory process – that the FCA will be a 'consumer champion'.
>
> (HM Treasury 2011: 80)

This would constitute a significant change from the way in which regulation operates currently and would bring it closer in line with regulation on the continent where outcomes are more central than processes (Reifner 2007).

Under the proposed new framework, the OFT's consumer credit responsibility would be transferred to the FCA. Also, second charge mortgage regulation will be transferred from the OFT to the FCA.

Notes

1 For example, in May 2009 the then Communities Secretary Hazel Blears proposed the introduction of a series of measures based on the US community reinvestment programmes.
2 Census tracts are small, relatively permanent statistical subdivisions of a county consisting of 1,500 to 8,000 persons. See http://www.census.gov/geo/www/cen_tract.html.
3 The racial categories represent a social-political construct for the race, or races, that respondents consider themselves to be and generally reflect a social definition of race. Office of Management and Budget defines the concept of race as outlined for the US Census as not scientific or anthropological and takes into account social and cultural characteristics as well as ancestry. The race categories include both racial and national-origin groups. Race and ethnicity are considered separate and distinct identities. Thus, in addition to their race or races, all respondents are categorised by membership in one of two ethnicities, which are 'Hispanic or Latino' and 'Not Hispanic or Latino'.
4 A 'higher cost' loan is any first lien mortgage with a rate spread of 3 percentage points or greater or a junior lien loan with a rate spread of 5 percentage points or greater.
5 National banks and thrifts are required by their regulatory agencies to report data on reason for denial.
6 CRA regulation.
7 The Office of Thrift Supervision (OTS) was another bank regulatory agency charged with the supervision of thrift institutions. However, the OTS will be merged with the OCC as part of the overhaul of financial services regulation.
8 Low-income individuals and geographies have a median family income of less than 50 per cent of area median income. Moderate-income individuals and geographies have a median family income of at least 50 per cent and less than 80 per cent of the area median income. See http://www2.fdic.gov/crapes/peterms.asp.
9 The asset thresholds for 'small', 'intermediate small', and 'large' banks for CRA purposes adjust annually based on changes in the average of the Consumer Price Index (CPI) for urban wage earners and clerical workers.
10 The FSA defines impaired credit history as borrowers with any of the following: arrears of three months or more on a previous loan in the last two years; CCJs over £500 in last three years; or being subject to a bankruptcy order or IVA at any time in the last three years.
11 Arrears are defined for MLAR purpose as loan amounts in arrear exceeding 1.5 per cent of borrower's current loan balance.
12 Type of community finance organisation lending and investing in deprived areas and underserved markets unable to access mainstream finance.
13 The federal Neighborhood Stabilization Program allocated funds to local governments for the purpose of purchasing vacant properties, rehabilitating them, and returning them to productive use. Communities in greatest need of this funding were identified by creating an index using HMDA data, property vacancy data from the US postal service, and data on foreclosure trends.
14 See 'The Color of Money' series written by Bill Dedman first published in the *Atlanta Journal Constitution* in May 1988. Complete series available at http://powerreporting.com/color/.
15 See testimony of Jay Brinkmann, Chief Economist and Senior Vice President of Research and Economics for the Mortgage Bankers Association, at hearings on potential revisions to the Home Mortgage Disclosure Act, 24 September 2010. Available at http://www.mbaa.org/NewsandMedia/PressCenter/74036.htm.
16 This report uses earlier definitions of 'large' and 'small' banks. Large banks are those with over US$250 million in assets, and small banks are those with less than US$250 million in assets.
17 Data from Federal Deposit Insurance Corporation.
18 See, for example, testimony of Anthony M. Yezer at US House of Representatives Committee on Financial Services Subcommittees on Housing and Community Opportunity and Financial Institutions and Consumer Credit, 30 March 2004. Available at https://www.chase.com/cm/chf/miscellaneous/file/document/yezer_hmda.pdf.
19 One of the external reviewers of a draft version of this report stated that ONS tended to apply very stringent restrictions to geographical identifiers. Based on that experience, the reviewer suggested that one would most likely only be able to publish detailed geographical data if there was no other personal information on it that would make it useful. The implication of this argument is that one would not be able to go further than the data currently published by the Bank of England.
20 http://group.barclays.com/Citizenship/Community-Investment/Community-Investment-support
21 RBS *Group Sustainability Report* 2010.
22 See http://www.fdic.gov.
23 Data from Federal Deposit Insurance Corporation.
24 Data from Federal Deposit Insurance Corporation.
25 A thrift is an organisation that primarily accepts savings account deposits and invests most of the proceeds in mortgages. Savings banks, savings and loan associations and credit unions are examples of thrift institutions. See http://www.ffiec.gov/nicpubweb/Content/HELP/Institution%20Type%20Description.htm.
26 http://www.bsa.org.uk/docs/statisticspdfs/mortgages/mortgage_market_share_summary.pdf.
27 http://www.bsa.org.uk/docs/statisticspdfs/housesav.pdf.
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32 http://www.bsa.org.uk/docs/statisticspdfs/mortgages/mortgage_market_share_summary.pdf.
33 http://www.bsa.org.uk/docs/statisticspdfs/housesav.pdf
34 http://www.woccu.org/memberserv/intlcusystem/icus_country?region=EU&c=GB.
35 http://www.cdfa.org.uk/about-cdfis/state-of-cdfis-research/.
36 Payday loans are offered to people in employment. The lender accepts a post-dated cheque for an amount (typically in the region of £100–£125) from which an advance is made less than the full amount. APR varies from around 900 per cent to in excess of 3,000 per cent on a £125 loan.

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