The Social Responsibility of Credit Institutions in the EU

Community Reinvestment and other Opportunities
for the Development of *Social Economy Banking*

European Summary and Recommendations

presented by
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A. MARKET FORCES TOWARDS SOCIAL BENEFIT

I. Theoretical background to the study

This report is concerned with increasing *social benefit* by improving the social responsibility of the credit institution and banking service providing sectors. The underlying assumptions are the following:

- Social benefit is here defined only as non-discrimination and universal maximisation of economic opportunity.
- Credit institutions are not accused of being socially irresponsible but they could do better in achieving social benefit.
- Financial services are strategically significant instruments in the maximisation or denial of economic opportunity.
- In the financial services sector, questions of accessibility and appropriateness of products and services are inextricably linked to the necessity of financial services and the barrier or filter that these pose to all economic actors.
- Social issues in banking are not the exclusive territory of marginal social economy banks, although their vanguard experience is worth evaluating. While some of their business may not to be appropriate for mainstream banks aiming to maximise profit, their underlying principles of providing universal economic opportunity and non-discrimination are compatible with the activities of practically all credit institutions. Many mainstream banks are involved in social economy banking, but they do not measure it as such, and few of them establish specialised units to conduct it. As a consequence they may miss out on opportunities for development of new areas of banking.
- Social economy banking activity is concerned with *using* financial services and products *directly* to achieve socially beneficial results, rather than putting faith in the trickle down approach. Thus in simple terms, among other things it is concerned with targeting investment towards employment creation and pitching financial products and services to all consumers including those on a low-income. Undeniably it presumes, for example, that it is beneficial to reduce unemployment and combat social exclusion, but otherwise it uses market principles and mechanisms in the same way as profit seeking organisations but generally includes in the definition of *profit* other *social or societal* utility elements.
- Socially responsible banking is not dependent on the status of the actor: it makes no difference if they are big or small, if their legal status is co-operative or stock-market quoted. The only useful criteria for evaluation is whether meaningful positive social outcomes form an essential part of institution policy and that these are made transparent. This transparency is a necessary condition for effective markets.

II. Products, services, channels and demand: trends and conflicts

Germany, France and the United Kingdom share three perceptible trends which bring the financial service issues which this study seeks to analyse sharply into focus.

This constellation of factors is anchored by

(a) an underlying shift towards individual financial responsibility and reliance on private financial service providers rather than the State for the majority of financial matters. Thus, in all three countries there is

- a continuing trend towards increasing home-ownership
- an increasing number of small employment creating business start-ups; and
- an ever more obvious need for people to plan their own retirement income.

Studies into the importance of consumer credit to balance life-time expenditure and earnings conflicts are very much illustrative of a universal dependency on credit and investments rather than State provision or earned income.

(b) The phenomenon of the withdrawal of the State is of paramount significance. Voter unpopularity with high taxation coupled with EMU convergence criteria are but two of the factors cutting down the traditional welfarist role of the State and pushing towards increasing privatisation of State bodies and functions. On one hand this leads to overall reduced efforts to compensation and producing opportunity outside the market. On the other hand, the technique of compensation and providing opportunity shifts channels: Where the public sector intervenes it increasingly uses market mechanisms and private undertakings - including credit institutions and voluntary organisations - which are seen as more efficient than traditional State involvement.

(c) Healthy competition between credit institutions has reduced margins and led to the phenomenon of *lean-banking* characterised by branch closure, automisation, standardisation and exclusion of unprofitable natural and legal persons from product and service considerations. What is significant here is that the trends in (a) all share a bias towards being relatively expensive to deliver and this conflicts with the principles of *lean-banking*.

III. Scope of the study

While some may argue that the social responsibility of credit institutions in the EU is to make profits, we query whether their strategic economic position coupled with their State charters and guaranteed deposit insurance renders them *quasi*-public or at least positioned to be more socially responsible than ordinary private undertakings. In any event, It is interesting to speculate on what basis is it acceptable for these institutions not to provide products and services to certain consumers, whether because of income-level, history of financial responsibility, nationality or other reason.

In the context of credit institutions wishing to establish a branch in another member State, the Second Banking Co-ordination Directive (89/646/EEC) refers to "the interest of the general good", pursuant to which a host banking supervisory authority may stipulate conditions under which such a branch must carry on its activities. (Article 19(4)). It also recognises that a host State may have adopted its own rules in the interests of the general good and the European Court of Justice has brought the interests of consumers, the protection of workers, and social order within the scope of the provision among other matters. In as far as the "interests of the general good" may include questions of social responsibility, this provision may be interpreted as an acknowledgement of the appropriateness of such regulation.

If there are persons who remain unattractive to all (mainstream) private financial service providers within the regulatory and competitive environment, does that mean there is a market failure or is this only a market effect which is entirely acceptable?

Access to a basic banking service was chosen for evaluation because it acts as a gateway for consumer access to advanced banking services such as credit as well as for other financial services. Micro-business start-up straddles many areas of interest. Some micro-businesses will be profitable in the short-term, some in the long-term and some will fail spectacularly quickly. But what differentiates micro-business from other business investments are the employment creation impact, the educational impact, local economic regeneration and the wider social impact of, again, providing individuals with the opportunity to be successful and take responsibility for their own income and career plan. And this is what links it not just to small business finance but also higher education and employment re-training finance - for some people, starting-up a micro-business is the equivalent of all these things.

And providing appropriate finance to people and organisations for social goals rather than those of profit is necessary to level the playing field between these very different organisations. If market economies are to encourage not-for-profit organisations to exist, then it seems inappropriate to discriminate against them in any way whatsoever, particularly in a way which makes them uncompetitive vis-à-vis for-profit undertakings.

In the area of mortgage finance, people generally want to buy their own home for security rather than investment for profit and this may be a *social goal* which the market cannot best work towards on its own or which it may misread and react inappropriately to. The integration of such social language into the realm of market principles is certainly problematic in theory and it is doubtless for this reason that some fiscal policies aim to encourage home ownership and act as a catalyst for private credit providers to supply the demand.

What should be the role of social economy financing actors in the EU? Whereas in the UK there is the making of a relatively strong base of private credit institutions working towards social goals through investment rather than charitable donations, even this is within a relatively neutral environment for such activity. Essentially, there are two points of view: either to regulate the financial services market with a view of achieving basic social goals or allow the market to stabilise naturally and accept the results, although this latter view also advocates the best possible information flow.

IV. Methodology

The country reports have been written by the project partners in the three countries with IFF co-ordinating the entire project and preparing the main report, drawing together the comparisons and conclusions. The CRA element is based on previous research undertaken in the USA by IFF.

The countries were chosen because of their contrasting home state regulatory frameworks and the specific areas of interest were settled because they are submitted as the problem areas most illustrative of *post-welfarist* conceptions of the social market economy. As already mentioned, a basic banking service is a gateway financial services product, micro-lending straddles issues of consumer and commercial credit and highlights features significant for all small business lending, home mortgage finance is becoming ever more important throughout the EU and voluntary organisations are increasingly depended on for the provision of a range of social services, formerly provided by the State as well as being an alternative to such centralised provision.

According to principles of social science research, the study partners have conducted group discussions with bankers, supervisory authorities, experts and others. In addition, standardised and semi-standardised questionnaires have been sent out and the results analysed. The partners have also drawn on their individual expertise and reviewed relevant literature.

B. KEY OBSERVATIONS AND FINDINGS IN THE COUNTRY REPORTS

I. Supply of Financial Services

1. Consumer access to a basic banking service

Financial services for consumers can be categorised into four areas:

- payment system
- credit
- savings and investment
- insurance

Within the payment system the bank account is the key to many other services such as funds transfer as well as overdraft credit and savings deposits and a bank account seems also to be the passport for many other financial services. This project has focussed on access to bank accounts which may serve as a valid indicator about possible trends towards discrimination in the future. Additional research will have to be done in the other areas.

(a) Current Account

Most people would recognise a basic banking service as a „current account“, a „Girokonto“ or a „compte courante“. In fact this *lifeline* service is made up of several elements collectively forming a *current*, as oppose to deposit, account. However there are also separate providers of individual elements of the service and we suggest it is important not to confine this evaluation to the products which are currently on offer, the way in which they are available (particularly in conjunction with one another) or from which providers they are available.

To help understanding, the type of services required as the lowest standard of *life-line* service are envisaged as the following -

Table 1: *Current basic banking service*

• Account number / Sorting code
• Unrestricted paper / electronic transfer of funds to and from account both as discrete transactions and regular mandates
• Cheque book
• Automated teller machine cash withdrawal
• Debit card (non-credit authorised) electronic payment at point of sale

and this compares to

Table 2: A*dvanced banking service*

•	Cheque guarantee card
•	Credit assessment for overdraft/loan
•	Etcetera...

In the abstract and sometimes in practice too, these elements can exist separately. It is only the actual account into which deposits are made which is really a matter of banking; the rest concerns instruments of payment, paper or electronic. Payment clearing and plastic cards are not tied to particular institutions but are really a service which banks pay for and then provide to their customers - for example, through BACS, the UK inter-bank clearing system or Visa International . The use of outsourcing of telephone banking services and ATM exchange agreements is also significant but the interrelationships are complex; in the abstract it would certainly seem sensible for all bank customers to have the use of all ATMs, but we have found that retail banking is not the most customer focused industry in the EU.

The UK report shows that it is possible to survive without a basic banking service - life is just more expensive. The highest incidence of consumers without a basic banking service is here where about 20% of the adult population (weighted more towards older people) manage their affairs outside the banking system. And it is not so much that there are gaps in the market, rather alternative banking service providers have stepped in. What is interesting in the UK is that everyone could open an account of some sort, probably a National Savings Ordinary Account in the Post Office (similar to the minimum service in France), but they choose not to, probably because this is not an *appropriate* service.

It is clear that the charging structure of bank accounts is not suited to all consumers. Although UK current accounts are generally free of charge when operated in credit, penalty charges are commonly levied out of all apparent proportion to the customer's behaviour. For people on a low-income, this is not an affordable service. And admittedly, less financially sophisticated and low-income consumers may be generally more time-consuming for banks. The expense of time, coupled with the lack of opportunity to cross-sell other bank products to customers who do not have very much money again illustrates the way banks actually seek to make money from their customers.

French banks are criticised by consumer groups for running up unnecessary extra costs when there are insufficient funds for payment. Essentially, the banks are accused of doing very good business out of this which again confirms the charging structure of bank services evident both in the UK and Germany. The question of why banks may have a rather short-term approach to the profitability of customers needs to be addressed. Expensive credit and banking service providers from the Anglo-Saxon world have arrived in France posing dilemmas since, whereas the *Loi bancaire* of 1984 prohibits the illegal exercise of banking business and very old laws make usury illegal, “Crazy George” has managed to bring its business outside of the scope of regulation, effectively charging interest rates of between 30-80%. Rather than selling consumer durables on credit, it rents out appliances with an option to buy. However, the major point to note here is that while this may be an expensive product, it is affordable and appreciated by the customers who use it, customers who would be refused credit from other sources.

In Germany in 1995, prompted by the saving banks, the ZKA (the banking industry body) made a recommendation that all German banks should provide a basic banking service to all consumers. This matter was debated in the German parliament in February 1997; although a lot of new accounts under these proposals for basic banking service had been opened already, consumer groups see a growing proportion of unserved clients and have criticised the fact that bank data has not shown the number of accounts that have been closed by the banks.

On this basis, a proposal has been adopted by the German parliament (made in February 1997, agreed in June 1997) to give banks two years to report on their respective positions relating to the provision of a basic banking service to all consumers and review the situation at that time.

Some social economy banking providers have traditionally offered elements of a basic banking service to low income consumers. For example, some building societies in the UK have operated a cheque clearing service through a customer's account and credit unions have traditionally placed no emphasis on the credit history of a customer when accepting them into membership, putting more reliance on the savings record of a customer in granting credit. Until 1986 Building Societies did not offer personal consumer credit so their basic banking service was not a full banking service. But, building societies have had difficulty in maintaining low deposit account facilities as speculators have sought to join societies for the sole purpose of seeking the transformation of the institution into a bank and obtaining a windfall distribution based on the assets of the society built up over in many cases nearly 150 years. Credit unions do not offer the coverage in the UK which is available in Ireland or the United States. With these exceptions social economy providers of basic banking services either are not in a position to or choose not to offer basic banking services to those refused access elsewhere.

In addition, advanced banking services appear to be a hurdle to accessing any basic services. Unfortunately it is through advanced services, for example by allowing all card holders DM 500 unauthorised credit and then charging for this service that banks see a way to make money. Computer software will be generally tailored to allow these card transactions, which for many people will not be problematic to cover later. However, for low-income consumers this may not be the case where such use of credit has not been budgeted for. This default provision of advanced banking services - such as in Germany - is thus doubly problematic since this is an inappropriate product which actually restricts access to an appropriate one. It is also relatively straightforward to argue from a consumer protection standpoint that this technique of selling is not helpful for people with a very limited income.

The consequences of not having a basic banking service are becoming ever more serious in all three countries. It is clear that life is more difficult without this financial service and it is certainly an obstacle to securing a job and somewhere to live in some circumstances. But the question remains whether everyone should have a current account; whereas it is desirable to generalise that they should, it may be better to qualify this by such a service should not be *unreasonably* withheld. This is particularly true for Germany and France where not having a bank account shows previous financial irresponsibility and even suggests exclusion from the workforce. It is usual for salaries to be paid into employees' accounts in all three countries.

In Germany, there is no transparency vis-à-vis the number of consumers without a bank account - the available figures appear to be in the region of 500,000 or 6% of the population. This frequently quoted figure is supported in the study by statistics for customers paying telephone and electricity bills in cash and of non-automated social benefit payments.

Traditionally, the savings banks in Germany have served low-income consumers with basic banking services. However, while still enjoying the largest market share in bank accounts, they do not consider themselves in a position to offer products and services to all those low income customers who have reportedly had their accounts closed by the privatised Postbank and who are not now attractive to profit-seeking credit institutions. This is essentially for two reasons: concern that being more active in this market sector would (i) imperil their profitability and (ii) create an image of "the bank for the poor" with negative side effects vis-à-vis attracting moderate and high income customers.

Access to a basic banking service may in some respects be viewed as a life-long passport to personal financial responsibility. The French situation, where there is a right to an account, is illustrative of the importance placed on the service by that regulatory framework. It does seem, however, that in practice this right is effectively reduced to a “Livret A” savings account provided through “La Poste” which does not necessarily fit our study’s conception of a basic banking service.

(1) Who pays for a basic banking service?

In France and Germany consumers are used to paying for elements of their banking services with a typical charge of DM 5-20 per month in Germany, but in none of the countries do banks actually charge consumers for exactly what they use, for example each cheque processed, whereas they do this for business accounts. Instead, banks aim to offset the cost of providing basic banking services through *selling* more advanced banking products such as credit and insurance. Significantly the UK has recently witnessed the introduction of some fee-paying accounts for additional services, although there is significant consumer resistance to being charged for a service which was previously free of charge.

This sourcing of funds to cover the costs of providing a basic banking service is problematic when it comes to provision for low-income consumers to whom little or no cross-selling of other products will be possible and who will always be inherently more expensive relative to their use of banking facilities and the amount of funds passing through their accounts. If banks are not transparent about what it costs to provide a basic banking service - and whereas some will disclose some information, the majority say there is no average - it is difficult to argue against their claims that it would not be good business to provide an account to everyone. For advocates of universal access to a basic banking service, this is a significant hurdle.

(2) A right to a basic banking service in France

Compared to the UK and Germany, the French situation deserves special contrast as a country in which this issue has been given some importance and a right to a bank account is provided for - 94 per cent of adults living in France have a bank account. Together with government, the French banking profession has organised a system of surveillance of self regulation vis-à-vis the right of consumer access to basic banking services. Under the *Conseil National de Credit, the Comité Consultatif* delivers a report on this issue each year. However, the report suggests that most private banks have left the very poorest areas and since most consumers choose their bank on the basis of location, it is mostly with La Poste which low-income consumers have their accounts.

Together with a 1992 Charter devised by the *Comité, Art 58 Loi Bancaire* is concerned with ensuring access to basic banking services for low-income consumers. In fact, French banks may refuse to open an account for someone but if they do agree they must offer the full range of services apart from a cheque book -

- *cash card (which must be free of charge)*
- *transfer facilities*
- *proof of bank details.*

In any event, banks must not fundamentally change the services offered when the account was first opened without reasonable notice and they are limited in the circumstances for which they can close an account - there is a comparison to be drawn here with the new UK Banking Code of practice. They must also disclose to customers the legal basis behind the right to a bank account.

The right to a personal bank account is a matter of "*ordre public*" in France and it is therefore for the state to ensure its efficacy. It seems that the actual regulation of access to a bank account as of right is done in a very minimal way - in fact the service that people essentially have a right to is a savings account, the "livret A" offered through the Post Office. And the almost inevitable privatisation of “La Poste” would seem significantly to endanger even this provision of a *life-line* banking service.

Annual reports of the *comité* showed a rise from 46,000 to 57,000 complaints between 1992-94, but those people who do not manage to get access in the first place are not included in these figures. It seems in fact that even in France some consumers are effectively excluded from the banking system.

(3) Interdits bancaires

And some of them will be *interdits bancaires*. It is interesting to contrast the right to an account with the high number of *interdits bancaires* in France, a country where overdraft facilities are rare and where writing cheques without sufficient funds to cover them (bouncing cheques) is a very serious matter. In 1993 there were fewer than one million *interdits bancaires* in France which rose to 1,27 million a year later following a change in the law relating to cheque payment. In 1997 the figure exceeds two million, 73% of whom have been outside the banking system for more than a year. Moreover it apparently becomes increasingly difficult for people to pay off their debts because of the financial penalties imposed by the banks. In this light the French example does not appear particularly desirable.

(b) Credit

The discussion of weekly collected credit in the context of access to a basic banking service in the United Kingdom report makes some significant points. Some 2-3 million people in the UK have civil debt judgements against them which generally excludes them from obtaining authorised credit from a bank. However, the basic banking service in the UK has provided a cheque book which enables unauthorised access to credit. Authorised credit from a bank is usually only available by the use of an overdraft for amounts of less than £500 and the lack of discipline of repayment of this facility, and to the extent that this is an inappropriate product may make this difficult for low-income consumers. The weekly collected credit service offered by *moneylenders* enables those without bank accounts and those with existing civil debt to obtain credit denied by banks. Involving some 1200 credit companies, the largest providers are companies listed on the Stock Exchange and the largest has some 10,000 agents working for it.

Essentially, the position is somewhat paradoxical. The demand for the credit element of a banking service is being met in the case of 2-3 million consumers by moneylending companies lending on average £350 for a 2 year period or less. As a weekly service delivered to the door it is very expensive for consumers, and profitable for the moneylending companies. In terms of APR disclosure the high costs of this service and product make it easy to criticise moneylending. However, unless it is argued that consumer credit is not a good facility, it is only the cost of this product which is questionable.

Access to credit for low-income consumers is related to access to a basic banking service because these products often require credit authorisation equivalent to a modest loan or overdraft request. Cheque guarantee cards and debit cards both allow the customer to spend more money than she has in her account, although recently a new type of debit card has been launched in the UK which does not permit this. This is a significant development for expanding access to a basic banking service.

The UK use of expensive credit by low-income consumers, together with the success of "Crazy George" in France highlights the significance of *affordable but expensive* modest credit in Europe in both existing and in future member states - the largest UK moneylender has established an operation in Poland and is looking to do so in the Czech Republic. Household debt in France runs at 33%, half of the figure in the UK. This is changing with the introduction of more products including overdrafts, more aggressive sales techniques and new entrants to the market which are reported not to take into account consumers' other monthly obligations.

There seem, therefore to be two issues:

(1) Access to a basic banking service is often restricted due to credit authorisation requirements which are inappropriate to the level of service actually required by the customer

(2) Low-income consumers do need access to consumer credit which is affordable in terms of regular repayments rather than in the total cost of credit.

Recent studies on household expenditures also reveal that low income consumers have credit lifecycles in which between the ages of 25 to 35 they will spend more than they earn, which, after a period of equilibrium between the ages of 35 and 45, may be repaid by the surplus they may reach after the age of 45. If this holds true then low income consumers need access to forms of long term fixed rate instalment credit even if the amounts of credit are so low that the profit expectations of suppliers may not be met. And it follows that the trend to refer them to short term credit facilities such as an overdraft or use of a credit card credit may significantly aggravate their situation.

(c) *Insurance, pensions and other* essential *products*

It is noted that there are significant other areas of supply of consumer financial products and services such as insurance and pensions. For example, in risk insurance it has been observed that whole areas of a city with an increasing risk structure may be *de facto redlined* in so far as no active marketing of household and car theft insurance is undertaken any more. Also, private pension plans are marketed primarily to clients who are likely to make higher contributions. More and more investment facilities require minimum investments so that low-income consumers are disfavoured and left with for example, capital life insurance endowment policies or German credit-savings plans which are not only sometimes less profitable than, for example, investment funds but have especially odd effects in case of early cancellation. Since nearly half of these contracts are in fact terminated early especially by the lower-income policy holders or savers who then have to renounce not only on the profit but sometimes even part of their savings, it may be argued that this money is shifted to the higher income-strata clients. To this extent such products, at least in their present form, are truly the wrong products for low income consumers but the market does not offer alternatives to them. This area might easily form the subject of comprehensive research and analysis and much has been done in this regard in the USA where the mutualisation of some risks across consumers is required by law and cherry picking of customers is prohibited. These matters will not, however, be considered in this report.

2. Commercial micro-finance

(a) background: very small firms and micro firms

The European Commission has recognised the necessity to differentiate between very small, small and medium sized enterprises and established a definition on this basis.[1]

Small enterprises comprise small and *very* small enterprises. The latter are made of less than 10 employees. Small enterprises have less than 50 employees. In the European Union there are 14,835 million very small and 1,015 million small firms representing 32,26 million and 18,825 million employees. See: European Network for SME Research: The European Observatory for SMEs, Fourth Annual Report 1996, page 47 and 49; Office Journal of the European Communities (Nr. L 107/6, 1996)

With the highest growth in employment in very small firms in Europe (between 1988 and 1997 at 0,5% per year according to the European Network of SME Research), the highest number of enterprises in that group (14,8 million out of 16 million total enterprises) and the second highest employment rate (32,2 million out of 99,58 total employment) the importance of access to appropriate financing is clear. Furthermore, a 1995 European study of the European Commission on Local Development and Employment Initiatives demonstrated that, particularly in personal services on a local level, a high potential for new enterprises and jobs exists all over Europe and that access to appropriate financing is one major obstacle for start-up.

Micro-business
For the purpose of this study *only one group of very small undertakings* was analysed: *micro enterprises*. They are defined as 1-3 person businesses with a need for loan finance up to 10,000 ECU for start-up and within the first three years of operation.

lending techniques for small and medium sized enterprises are inappropriate and insufficient

The country reports identified that the following topics are the major reasons why financing services of banks for small and medium sized business do not often work for micro businesses. *Micro-lending is characterised by very small borrowing requirements (10,000 ECU), relatively high administration costs and poor short-term profitability prospects.*

- Micro-Entrepreneurs ask for such low amounts of loan finance that banks have problems in covering their transaction costs. A credit worthiness evaluation costs around DM 1.500 according to the German saving banks which means that with one percent share after risk and refinancing costs a loan would still have to be of over

150.000 DM to be profitable in the first year. Even public supported Loan Guarantee Schemes (LGS) are not always be open for small sums as the average of nearly 200.000 ECU in Germany and over 300.000 ECU in France demonstrates. In the UK, it was interesting to find that the average small business loan provided by banks was close to 10.000 ECU which brings them within the range of micro lending. The Small Loans Guarantee Scheme in the UK supports an average loan of just above 50.000 ECU. There is a minimum loan of 6.500 ECU except in urban regeneration areas where it can be as little as 650 ECU. However the value of guarantees issued in the UK at 300 million ECU is less than a sixth of the value in Germany and less than a seventh in France according to European SME Research.

- *Micro-entrepreneurs need a different product.* Basing its analysis on successful international private sector micro lending schemes, the German country report makes clear that loan products for micro enterprises need a different credit worthiness evaluation, different security basis, different acquisition techniques and a tailor made support and coaching strategy.

In common with most small firms but not necessarily most medium sized firms:

- micro enterprises rely on loan-finance rather than equity. Access to other capital sources is limited: most of the businesses lack the profitability potential to be attractive to venture capitalists; they lack the size to become quoted on the primary, secondary or third stock market; and they lack the professionalism and often contacts to make use of government programmes such as the UK Enterprise Investment Scheme, which encourages investment by individuals in unlisted companies.
- micro enterprises are often unable to fulfil the formal, rigid criteria required by venture capital institutions and commercial banks to obtain loans. For example, these applicants tend not to have collateral, business qualifications or very well thought out business plans. Moreover, the traditional lenders have not traditionally provided any assistance to fill these gaps. Schemes are now being piloted in the UK to reduce the interest rate on loans to entrepreneurs who have had training one year after they set up in business. Other schemes are also looking at providing business training to entrepreneurs before loans are provided.

But even if banks and other institutions in the traditional financial sector were willing to finance these firms, the transaction costs may be such that the endeavour would not be sustainable. These institutions would be hard-pressed to balance their need to make a profit and the additional 'costs' that would be incurred in micro-lending. This has resulted in a growth in other forms of loan-finance including:

- secured loans on private homes;
- wholesale investment of personal financial resources such as savings, pensions and life insurance;

- inter-family lending; and
- occasionally more expensive forms of finance such as personal credit cards.

While this may work in same cases, *overall* it is *inappropriate and insufficient.*

- Inappropriate because this kind of “second best” finance
  - increases the danger of insolvency due to poor quality of finance;
  - such insolvency becomes a threat to the social welfare of the entrepreneur and his/ her family;
  - lacks support instruments helping to achieve the economic potential of micro-enterprises;
- Insufficient because it limits access to finance for most potential entrepreneurs on a basis not correlated with their economic success position.

(b) appropriate lending techniques

With ADIE in France and the Prince’s Youth Business Trust (PYBT) in the UK two micro-lenders were seen as demonstrating the adaptability of international successful lending techniques in Europe. By investigating these organisations together with techniques of Working Capital in the US and the famous Grameen Bank in Bangladesh (which are used in adapted forms in Europe) some keys of success in lending to micro business (more detailed in the German country report, chapter 4) could be identified:

- a new credit worthiness evaluation: eliminating the traditional way of evaluating the credit worthiness of the potential entrepreneur, - instead using new techniques such as working with external insiders as agents (business angels), with a risk minimising technique called *stepping*, saving periods in front of the loan, a business plan rather than collateral oriented approach and forming lending groups controlling and helping each other called “peer groups”;
- different collateral: eliminating traditional forms of using collateral, - using instead new forms of collateral as limited personal collateral of friends or exchange of limited collateral and common equity saving in the peer group;
- reducing risk with strong support mechanism which at the same time are designed cost efficient by using self support manuals (“self help kits”), external specialists, group training, voluntary experts (“business angels”);
- effective acquisition of potential clients through co-operating banks, grass route acquisition and filtering techniques such as standardised information workshops before a more individual approach is offered.

Out of success factors such as those identified a lending strategy for micro-businesses has to be formulated in correlation with the cultural and economic environment and the conditions of the lender. Such an appropriate lending technique to micro business is defined as Micro Lending.

(c) insufficient supply of Micro Lending in Europe

All country reports identified insufficient supply of Micro Lending using the above definition. In none of the three countries did a major bank deliver a service comparable to Micro Lending: some loan programmes do not deliver loans of that small amount and few bank support programmes exist which support and motivate potential founders to develop a business plan and loan application. With ADIE in France and PYBT in the UK private sector initiatives deliver Micro Lending schemes but their coverage is insufficient due to limitations in regional and client focus. Both initiatives co-operate with banks but were started and still run by the voluntary sector.

In no country could a supply standard be found comparable with the US which has more than 400 Micro Lenders. However, reasons for an insufficient supply vary in the three countries:

(i) Germany:

In general terms, Germany's success in lending to small and medium sized enterprises - related to the efficient public support system through guarantee companies and public refinance banks - leads to a complete lack of appropriate services to micro firms.

While in Germany there is an internationally well known supply of long term bank finance for the Mittelstand in general, its strength seem to be at the same time reason for the weaknesses analysed below:

- the public support system is working mainly through public refinancing banks (financed by low costs on the capital market and direct subsidy) giving the entrepreneur cheap long term credit and long term credit with equity character; and through guarantee companies (financed by state counter guarantees and charges to the clients). In any case, the entrepreneur reaches these public programmes only through its house bank. While this is in general a very efficient technique preventing too much bureaucracy, it proves to be the wrong tool for micro entrepreneurs. House banks prove to be a bottle neck for projects with small sums, not well developed business plans and entrepreneurs lacking security - all the typical things identifying a micro entrepreneur. The guarantee companies, where applicants with a lack of security, are referred, are also not keen on small sums and high development effort and at best they refer business plan development to chambers of commerce. The chambers, which are famous for their support system, typically lack the access and responsibility for this market segment where often you find entrepreneurs who have not been through the traditional apprenticeship system. To summarise: the German system was constructed for the Mittelstand and not for micro entrepreneurs. This is obvious by looking into the high application standards asked for and the internal fee system which gives the house bank a more or less fixed administration fee (0,75-1,25% of the credit sum) which is a very small payment to the house banks. The result is that the overall percentage of publicly supported small firms is around 17%, and public refinance budgets are never used to the full with house banks creating a wide range of excuses not to use them.

- In addition, the quality of financing products for small firms in general has not improved due to the fixed environment of public support. Other than the UK, where after very negative experience with banks small firm involvement at the end of the 1980s, improvements in the quality of products and support systems were implemented, the German Mittelstand financing system is still perceived of as the best in the world by German banks. All the players involved in the financing system (the state, the house banks, the public refinance banks) put the blame on each other for any shortcomings, the result of which is that a new technique such as micro lending is untried or untested. At the same time, the numbers of small firm insolvencies in Germany are rising. According to studies of 10 to 20 cases done in the IFF, it appears likely that the primary cause of more than 30% of insolvencies has been the poor quality of financing.

So for the German situation it has to be said that while the system of loan financing the Mittelstand is internationally recognised for its effectiveness, it has growing problems. This becomes apparent, in particular, in the area of micro finance where the institutional framework of public support does not fit anymore.

(ii) France

With a well developed state intervention system into financing small and medium sized enterprises France seems to have equal problems to Germany in terms of serving the medium sized rather than the very small firms. SOFARIS, the State loan guarantee scheme is praised because of the simplicity of its operation – *quasi*- automatic guarantee of 80% of loan value made by the major banks to businesses under three years old with a ceiling of FF 50,000. The scheme makes this area of business attractive which would otherwise not have been able to raise finance.

One major problem of French banks’ small firm involvement seems to be linked to staff recruitment and training; by recruiting mainly graduates from University as lending managers a long term relationship between corporate customer and the banker is difficult. The recruited graduate starts inexperienced without knowing much about the business environment of the local branch and leaves the branch typically after two years aiming for the next career step. In Germany, the changes in branch management are fewer due to a system of apprenticeship and internal career steps.

(iii) United Kingdom

Notwithstanding the Small Firms Loan Guarantee Scheme, weaknesses in the scheme and in lending to small firms has been highlighted by the involvement of the Bank of England in monitoring finance for small firms in the last few years. The Bank of

England conducts a quarterly survey of bank lending to small business and pulls together information gained from its regional officers who have responsibility for monitoring regional economies. In many respects it is something of a voluntary Community Reinvestment survey except it does not break down its data into specific areas of deprivation. It has more recently started to focus on high technology small firms.

Moreover one in four local authorities have their own small firm loans scheme, some operated with banks, as well as some 80 or more other loan schemes for small business often arising out of partnerships between local authorities and other state agencies, such as Business Links and Training and Enterprise Councils.

The situation in France and the UK is characterised by the intervention of intermediaries who essentially undertake a *pin ball machine role* with entrepreneurs learning a little more and refining their business plan and loan application as they move from one adviser, or bank to the other, before they have success, failure or reach a lender of last resort, which not only unlocks its own finance but often levers in a bank too. Thus in the UK the Prince's Youth Business Trust has been extremely successful as a lender of last resort and is widely supported by mainstream retail banks at a very high level and in France ADIE undertakes a very similar role. However, the banks only seem to be willing to sponsor these Micro Lending initiatives and co-operate by offering for example zero interest refinancing capital and recruiting potential clients from their branches. This does not lead them into offering Micro Lending schemes themselves or taking a higher responsibility.

(d) the strengths and weaknesses of Micro Lending

While there is room for improvement in sustainability of many of the existing micro lenders, for example ADIE and PYBT, it has to be said that the nature of the business (high support for low lending volumes) sets clear limits to sustainability. Compared with other banking activities Micro Lending needs longer term finance and probably will never achieve average profitability over a portfolio. Therefore it has to be noted that the low interest of bankers to be involved directly has a sensible economic base.

On the other hand Micro Lending delivers very positive results in respect to costs of delivering employment. A range of studies on behalf of the European Commission and the OECD came to results of costs per job between 3-10.000 ECU. If an independent micro-lending scheme was established with the support of a bank a model calculation on behalf of a German savings bank by IFF, documented in the country report for Germany, showed that public provision of DM 5000 per successful self-employment loan could make micro lending a profitable activity if international best practise is implemented.

A high involvement of mainstream banks in the process of delivering and developing appropriate services for micro enterprises is seen as desirable due to the know-how impact, the chance to work cost-efficiently by using existing infrastructure and the chance to deliver a European wide service.

In France for example access to micro-finance is not regulated in the same way as for a bank account and it seems that many micro-entrepreneurs will go to a bank before having comprehensively worked out a business plan, which does not give the bank much confidence in the project. Banks lost a lot of money in small business lending at the end of the 1980s and coupled with a lack of realism – entrepreneurs may expect the bank to share all of the risks of the new business - bankers are quick to dismiss proposals. However small businesses in general consistently contributes the highest percentage of new job creation. 50% of businesses survive past 5 years, with new businesses making up half of the 60,000 insolvencies in 1995. There are various factors which seem to make failure less likely including: advice taken before start-up, the greater number of employees the better, and doing something which the entrepreneur already has experience of. In this respect banks could better assess their risk, by a more refined analysis of positive and negative risk factors.

For example, out of 125 business start-ups studied in *Ile de France*, 36% of proposals were greeted by absolute refusal, 10% received a loan lower than their requirements, 59% had to approach between 2-5 banks and 36% of applications were refused by more than two banks. In fact, 35% of banks claimed not to finance business start-up. A 1994 survey suggests that to receive a loan, would be entrepreneurs need significant amounts of their own capital – 67% of persons received a loan with more than FF 500,000 compared with only 15% of those with less than FF 100,000.

Although profitability perspectives look limited, there seem to be some reasons for banks to get involved: the potential for developing new profitable customer groups; the potential to show public opinion their positive impact on producing social wealth; and the potential for applying the new techniques necessary for this market segment to other market segments facing profitability challenges due to high transaction costs and high risk. Moreover there may be some self-interest for banks in ensuring that higher subsidised services through state taxation are avoided. For whatever reason, there are some signals that mainstream banks, which, at the moment, at most *sponsor* such initiatives, are starting to become interested in the techniques of Micro Lending.

3. Access to home mortgage finance for low and middle income families

Home ownership finance is a major focus of the American CRA due to the strong positive impact home ownership delivers to communities and to families. For the purpose of this study access to home ownership finance was investigated in Germany where the lowest percentage of home ownership in Europe is apparent.

In 1996, in the former West Germany only 42% of households were home owners and in the former GDR only 27%. The need for a 20-30% deposit, together with the inflated costs of real property make house purchase very difficult to achieve for many people living in Germany. State subsidy is significant (for example, DM 56.000 for a family with two children building their own house) but unfortunately it is only affordable by the families who able to obtain finance - typically the upper middle class.

Perhaps the most problematic aspect of German mortgage finance products and services is the fact that they are not directed at persons who want to live in a house but rather confuse investment motives in the equation, rendering products attractive only to wealthy people who can raise a significant deposit and commit to an inflexible long-term repayment schedule.

By using the average income of a private household in 1992, the average cost for building a small house or buying an existing house or flat and the typical financial product (including all possible state subsidy) it becomes transparent that :

- 52% of all households have to use more than 61% of their income after tax to finance home ownership;
- a group of 26% of all households have to use between 37-61% (due to increased state subsidy with children 32-53%) of their income - which becomes realistic but stays risky;
- only 13% have to use less than 37% (with children 32%) of their after tax income and can therefore be identified as potential clients for home ownership.

The middle group is defined as „Schwellenhaushalte" – people who can *almost* afford to buy their own home. For that group the technique of home ownership financing in Germany is currently seen as inappropriate:

- the required equity of 20-30% is typically non-existent
- the state subsidy is not able to lower the monthly costs to an amount this group can afford without taking too much risk of personal bankruptcy

In addition, general problems of home ownership are relevant for this group:

- decreased mobility due to ownership meets increasing mobility requests of the employment environment,
- financing insecurity with getting unemployed, losing a second income with family allowance (*Familiengründung*) and higher expenses with divorce,
- financial products are inflexible which becomes dangerous when changes in the preconditions occur - for example a 12 month period of unemployment of the home owner.

As a consequence, *Schwellenhaushalte* are forced to remain as tenants or accept high risks when financing home ownership. The enormous amount of State subsidy provided by the government obviously benefits higher income-strata families rather those with more modest incomes.

While this situation seems to be particularly relevant for the German situation where high deposit requirements exist and average costs for construction as well as existing houses is high, the nature of the problem is relevant for all European countries:

- only with financial products and subsidy systems developed focusing on the needs of all consumers, including low and medium income clients will an increase in home ownership and decrease of failed home ownership finance seem to be possible.

But the existing products especially in Germany and France reflect a philosophy that does not meet the new needs of the lower middle classes in their demand for mortgage loans and in the UK is not adapted to the “flexible” labour market where stable employment is not guaranteed and spells in and out of employment or between full and part-time work are reportedly becoming the norm. Contemporary products assume that home ownership is primarily looked at as a means to develop wealth or as some kind of retirement income resource. It therefore requires

- own capital,
- a sufficiently high repayment to cover not only accrued interest but also gain equity in the real estate

The credit products have little flexibility and assume that debtors have a stable income. Additional credit demand after the first mortgage has been given is difficult to incorporate into the credit structure.

Those products which had a collective element in order to facilitate access to home ownership for low income households like the *épargne logement* in France and *Bausparen* in Germany unrealistically assume that low income households are able to wait and save for several years until they acquire property.

Instead the situation has changed dramatically. The prime aim of home ownership is to get a place to live which the rented market may not always supply sufficiently at reasonable prices. Such households have neither the chance nor the intention to build up equity or use home ownership as a means of saving. Their narrow margin of liquidity confronts them with enormous risk which needs high flexibility. The traditional idea of collective self help in home ownership would therefore have to be reinvented in the credit part of the home ownership plans instead of its savings components. One model in that direction was illustrated with the *Mieterfonds* in the German country report

4. Access to finance for voluntary organisations

This part of the study is based solely on research undertaken in the UK. Depending on the precise definition used for the voluntary sector, its total annual income in 1990/1991 was between £8.4bn and £29.5bn. In overall terms, the sector is growing although its resources are reported to be subject to dramatic fluctuations and uneven distribution.

Over 90% of the 200, 000 *charities* (a sub-group of voluntary organisations) in Great Britain have an income of less than 120.000 ECU a year. The Charities Aid Foundation (CAF) have surveyed charities with annual incomes between 120.000 ECU and 12 million ECU. Whilst 85% of staff responsible for finance had had finance training nearly a third of respondents considered that lack of financial expertise was still a problem. The lack of sufficient financial expertise is problematic because the funding base of many charities is fragile. Fifty per cent of organisations claim unpredictability is a problem, and 34 per cent consider themselves too reliant on one source of funding.

(a) Demand

The advanced, professionalised status of many UK voluntary organisations makes them a very good focus for evaluating the reflexiveness of financial service provision to new demand. In brief, providers have not responded to anything like the position in the USA where 70% of charitable non-profit making organisations borrow. Among their reasons for borrowing are

- the pursuit of current objectives
- bridging current needs against future receipts
- investment to allow diversification into related areas of activity
- investment to improve service levels
- improving quality or lowering costs by achieving economies of scale

The UK country report's scrutiny of this area of financial services and product provision has found that at least £512.3m is lent annually to charities from a variety of sources, of which £216m was from UK Banks. As a group, housing associations account for the most significant non commercial borrowing activity in the UK, having borrowed around £4.5bn in the five years following the 1988 Housing Act. However, borrowing among charities is quite evenly spread among the different types of organisation.

The UK voluntary sector is very innovative and the report highlights a shift in approach and scope of the work of some of this far from homogenous group towards being run just like businesses only without a profit motive. Thus they are opening and running retail outlets and undertaking "contracted-out" work for local authorities and health authorities, for example running residential care homes for the elderly. With these phenomena has come a need for increased financial flexibility.

And with fund-raising having become an increasingly competitive activity for charities with relatively fixed grant income, borrowing is now the most obvious option to finance project commitments in the shorter term. The most important factor is that voluntary organisations' income fluctuates while their outgoing commitments become ever more steady. It is very much a *commercial* reality that voluntary organisations must honour their commitments whether their receipts come in on time or not, especially when their activities may no longer be merely supplemental to welfare state provision.

There are really two elements here. One is that of voluntary organisations borrowing money generally, perhaps from mainstream financial institutions. The other is that of larger voluntary organisations, which will be charities, undertaking their grant making function in the form of loans; that is, voluntary organisations making loans to other voluntary organisations or undertakings.

(b) Barriers

Factors thought to be holding back the development of a loans market include resistance to borrowing among the trustees of charities who have overall responsibility for operations and a reluctance on the part of commercial banks to lend to not-for-profit groups, often due to a real lack of security for loan-financing but possibly also because of a presumption, which is not very accurate, that professional financial management cannot be assumed.

The financial dependence of much of the voluntary sector on national and local government for a proportion of their income is undisputed. For many organisations their existence depends on continued access to public spending rounds, even though donations from the public, from the corporate sector, from other charities and the National Lottery are significant.

Existing legal and fiscal arrangements give voluntary organisations in general, and charities in particular, both advantages and disadvantages when compared to private sector operators. For example, while they have favoured tax-treatment, their inability to offer returns to shareholders (because they cannot distribute profit) may also limit their access to capital, and make them relatively less responsive than their "for-profit" counterparts.

Thus it seems that, even though charities take on spending commitments which demand regular payments they may not see or have the option of bridging funding gaps by borrowing money. UK lenders are reported gradually to be coming to terms with this but some view them as being unlikely to embrace it sufficiently. Secondments to voluntary organisations by retail banks together with the appointment of staff to develop business in the area is significant, but beyond the larger nationally known charities, charity finance is reported as remaining within the marginal development banking sphere.

(c) Outlook

Echoing the problems faced by small and medium sized commercial undertakings, managing the finances of the voluntary sector has become increasingly difficult, partly because of the growth of new funding sources. A general lack of long-term financial planning and unpredictable or short-term income sources are closely linked and together with a need for greater expertise in this area, there is a clear need for loan finance to be more readily available. The need for expertise is on the part of both charities and banks. The slow development of lending to housing associations, now a multi-billion loan market, and to universities, has indicated that over time banks and charities can build up expertise to develop new products which link the wholesale markets with the social economy.

Existing mainstream banking products seem to be tailored more towards banking services as opposed to credit products but there is an element of poor information flow between the voluntary and banking sectors making this area more complex. It is interesting that banks may develop expertise in this sector by default simply by having a branch in an area where many charities are based, but the internal problem of poor communication does not permit development of products or marketing to appropriate organisations.

Particular problems may occur in finding matching funding which is now a requirement for many national and European Union grant regimes. Some of this may be capable of being met by appropriate loan finance but it is possible that this might be better derived from regional medium term bond finance invested in the social economy than through bank lending.

II. Macroeconomic and legal instruments - existing competencies vis-à-vis insufficient and inappropriate supply

In the three countries, macroeconomic and legal instruments touching on our areas of concern were evaluated. These are subdivided in the following way:

- market externals: state regulation
- specialist suppliers
- Direct state involvement through subsidy and service provision

1. Market externals: state regulation

This section's presentation is problematic because in none of the three countries does any single body consistently display any competence to oversee the financial services market, especially not the question of access to it where one is concerned with actors who are not yet within the boundaries of financial services provision *because they have no access*. Thus, the question presumes some sort of right of access, or at least the desirability of facilitating access as a public policy issue.

And it is not just the question of access but also sufficiency and appropriateness of supply - *quantity and quality* - which again suggests an abstract benchmarking of what is and is not specifically desirable, additional to the desirability of access in general.

In Germany and the United Kingdom, the independent central banks are responsible for creating a generally healthy economic environment and achieving monetary policy goals, including low inflation. The Banque de France has a much stronger consumer protection function and goes as far as regulating standard banking consumer contracts. The *Comité consultatif du conseil de credit* has a presence in each department.

The banks' financial sector and banking supervisory competence vary but common responsibilities are essentially issues of system stability and general economic buoyancy rather than the direct pursuit of social utility goals, although these do perceptively lie behind their functions.

One qualification to this presentation is the Bank of England's focus on small firm and more recently high technology small firm finance following the prompting of the then UK finance minister at the beginning of the 1990s. This highlights the actual and potential competence for the Bank of England to *encourage* the private banks which it supervises to focus their attention on a particular area of financial services provision.

In fact the Bank of England has the task of seeking to ensure the effectiveness of the UK's financial services, including promoting access to capital for firms of all sizes and it can act as a catalyst to collective action where market forces alone are deficient. To be precise, the Bank of England has the task of "... keeping under review... developments in the field of banking which appear to it to be relevant to the exercise of its powers and the discharge of its duties"

The German *Bundesaufsichtsamt für Kreditwesen* (BAKRED) is, according to the KWG law only responsible for deposit protection and protection of the bank system from systemic risk. "The relationship of bank and customer is not in the focus ... and could even lead to interest conflicts" said the president of the BAKRED in December 1996.

Significantly, a new regulatory authority "NewRO" will shortly take-over *inter alia* the Bank of England's supervision and surveillance functions and already it is perceptible that there will be an increased level of consumer interest regulation of banking in the UK. However, while several government departments may be jointly concerned with the issues raised in this study, none has a clear policy or co-ordinating role, and it is uncertain whether it will be responsible not only for consumer interests of persons who have access to the banking and financial services products, but also to those who have no access or inadequate choice of products. In addition, it is not yet proposed that the regulation of consumer credit providers, probably the largest group of non credit institution lenders to low income consumers falls within the remit of NewRo.

The "Banking Code" of the British Bankers' Association together with the "Statement of Principles" relating to banks' relationships with businesses are voluntary agreements made by signatory institutions. Again there is now an increased level of consumer interest representation on the Banking Code Review Body, together with senior retail bank representatives . Both documents are designed to promote good practice rather than enforce banks to behave in a certain way and it is interesting to compare this situation with the powers of the French *conseil national de crédit* where in a tripartite committee under the auspices of the Banque de France important recommendations and regulations are made.

Together with government, the French banking profession has organised a system of surveillance of self regulation vis-à-vis the right of consumer access to basic banking services. Under the *Conseil National de Credit*, the *Comité Consultatif* delivers a report on this issue each year. However, most private banks have left the very poorest areas and since most consumers choose their bank on the basis of location, it is with *La Poste* which many low-income consumers have their accounts.

The French system is in many ways different from the German and the British system. The *Banque de France* has firstly a network of branch offices in all departments of France and secondly has far reaching competencies as far as consumer protection and even social issues are concerned. Similar to the Federal Reserve Board in Washington the *Banque de France* has a department which monitors consumer protection issues, makes proposals as well as keeping close relations with the consumer movement. In the *loi Neiertz*, the French bankruptcy procedure for consumers, the Bank of France has the task to administer and preside over the nationwide committees which (with the participation of creditors as well as consumer or other social organisations) have been introduced to seek relief for overindebted consumers through developing debt rescheduling. To supervise such tasks would be unthinkable for the *Bundesbank* for example.

But as far as community reinvestment is concerned the French example does not seem to have any more impact in this area than the respective institutions in the other countries. Its social focus is especially concerned with individual bank-client relationships and not with bank policies. In this field the *Banque de France*, which has a much wider range of tasks than its German or British counterparts, has no higher profile in community reinvestment. Unlike in the US, in the European tradition of banking, special socially oriented banks play a significant role.

2. Suppliers: banks and other finance institutions

As a consequence of the market imperfections in the delivery of banking services which have and are continuing to emerge as competition between banks increases, new banking providers are entering the market and a number of smaller banking and credit organisations have been established to meet some of the gaps. These new banks and financial organisations often concentrate on certain aspects of social economy banking.

To draw a comparison with the USA, South Shore Bank in Chicago seems to be a good example of a $0.5bn bank that has had an enormous effect in successful community reinvestment in a number of limited geographic areas. In Europe this local focus has generally been absent, instead it has been a development more relating to particular interest groups or sectors. There is an important number of small size banks that are only small because they serve a special client base with special knowledge and products. In other cases it was not the size of the bank but its special purpose or ownership or the clients they addressed which supported a broader community orientation than others.

Indeed small banks have also important disadvantages for community reinvestment. They have less possibilities to specialise in areas like small business lending or consumer credit and a basic banking service. They may also have fewer opportunities to spread their risks across a range of products.

This does not mean that being small has no positive effects at all. Credit extension for job creation as well as local investment seem to be done much more adequately with a feeling for its potential than computerised scoring in bigger banks. But only if such small banks have access to larger banks through their collectively held bank central administrations do they seem to have a fair chance of combining their local skills with the advantages of centralisation. At least in France small did not mean insecure until now as it has been experienced in the savings and loan crisis in the US as well as in the Nordic countries. French banks have traditionally maintained a dense network of small branches, 55% of which employ fewer than 8 persons. It was the centralised state owned banks which suffered most during what might be termed the French banking crisis.

But more important than size seem to be ownership. In some cases State influence in others special purpose banks which target clients with an empathy for the bank even if interest rates are not as competitive as other banks.

(a) State banks

State banks ought to be the ideal partner for community reinvestment purposes because they should, at least in theory, be linked to the public good. But this may only be in theory. Such banks often no longer have special advantages in refinancing and security and the state is not willing to support less productive institutions for the purpose of exercising direct political influence. At least the wave of bank privatisation points to the fact that state banks do not seem to be a solution for community investment in the long term.

Although limited in their market segment of basic banking services in all countries, the public post office banks have been an efficient instrument ensuring access. Especially in France this seems still to be the case. With 6 million accounts with balances of less than FF 1,000 accounting for 40% of its operations, La Poste provides default basic banking services. But there are doubts in the French banking community whether the state support received by the Postbank for supplying basic bank services does not outweigh the social result.

48 million people in France have a *livret A* savings account which pays interest net of tax to all savers and, through its control of the rate of interest on these accounts also works as an instrument for government intervention in economic policy to encourage saving and reduce inflation. In recent years a new *"livret jeunes",* which is a similar product designed for young savers has become available through all the banks. The Association of French Banks (AFB) has suggested it could handle the operation of livret A accounts for a smaller percentage than the two institutions which currently have the rights.

The fact is that the livret A account subsidises post offices, particularly rural ones for whom it makes up 70% of their business. And if the banks took over the provision of this account it is suggested that it would lose its socially beneficial character because of the cost implications of private banks offering it to everyone, whatever the size of their balance. In fact, this account is used by many people on modest incomes as a current account.

There is also other pressure on the status of the French Postbank. The French bankers' association accused *La Poste* of abusing its dominant position at the same time as the EC Commission presented a new proposal to dismantle national postal services from public hands. The French competition authority ruled there should be transparency in the relationship and in the costs of all activities undertaken, but *La Poste* is under attack from all sides. The concentration of low income customers with this public body may therefore prove dangerous in the light of privatisation or at least a pressure for higher profitability and less state support.

This has become clear by the privatisation of the German Postbank which had been in a similar social position as its French counterpart. Since the German Postbank has been privatised it started systematically to send expensive low income customers to the savings banks and attract new wealthier clients.

Other state banks have become rare in Europe. In the UK there are none left following the privatisation of the Post Office Girobank. Although the role of basic banking service provider for the Post Office in the UK has been suggested by research into access to a bank service. In Germany, state banks for special purposes like the *Kreditanstalt für Wiederaufbau* and *Deutsche Ausgleichsbanks* still exist and presently play a major role in the distribution of credit subsidies. However, they work only as a refinancer of banks with the aim of ensuring access to affordable loan capital for the Mittelstand and special purposes such as investment in ecologically friendly production.

It is argued variously in the chapters on commercial micro-finance that the programmes available do not work efficiently in the area of micro-finance. It could be interpreted as a symptom that State banks set up to fulfil a specific aim have problems in staying flexible enough in redirecting their service with a changing environment and demands. They are part of a bureaucratic system and hindered in their flexibility by that. However, it is not quite that simple : *Deutsche Ausgleichsbank* has implemented a range of changes appropriate to improve service, in particular the Round Table initiative to save firms in danger of insolvency is a very successful paradigm in the world of banking in Europe. However, overall the German state banks deliver services only through house banks and while being evaluated as very efficient for years, currently this system has problems due to decreased co-operation of the house banks.

(b) Savings banks

Unlike State owned banks German savings banks are owned by the cities and chartered in a way that their links to the community are more informal than formal. The German savings banks which have a public obligation (*öffentlicher Auftrag*) and are bound by regional limitations (*Regionalprinzip*) do show some clear activity in preventing insufficient supply, particularly due to their regional commitment. They are generally very strong in lending to small firms, local government and in sponsoring local initiatives. Their protection, through transnational saving banks and giro central administrations who give them and their clients access to global and sophisticated products as well as to larger businesses, guarantees their actual profitability which somehow contradicts the general assumption that state owned commercial actors are always less developed than commercial banks. However, with growing competition they seem not to be in a position to build on their efforts in this direction.

In the areas of basic banking services and commercial micro-finance it seems unlikely that these institutions will increase their activity without prompting. Although committed to supporting local development, savings banks do not want to become the banks of the poor or for social problems. This could be clearly seen in the debate about provision of bank accounts where the regional independent saving banks felt that they could not afford taking over the clients thrown out by the privatised Postbank and as a consequence tried to force the other banks with an self-regulating initiative to supply unserved customers.

The saving banks in France are very tiny compared with their German counterparts and in consequence have hardly any influence on the sufficient supply of financial services. *Caisses d'epargne* numbers dropped from 186 in 1983 to 31 in 1991 due to a succession of mergers and acquisitions and the establishment of a central office in 1995. The *Loi de 1983* confirmed their non-profit making status and it is from this that they get their particularly social goals. In opposition to their German counterparts, French saving banks are not owned and under control by local government.

It is these institutions which most obviously share the principles of Community Reinvestment outlined elsewhere in this study. Together with *La Poste* they are able to offer the government promoted tax efficient savings product "*livret A*" and they enjoy an above industry average liquidity ratio. In fact they do not actually own their *own capital*, which has been donated from various private and public sources since the 19th Century. They direct their resources "for the profit of the local and social economy" but their status does not allow them access to the capital markets.

From a competition standpoint they have been criticised by French private banks and the latter's industry association, the AFB. Reform proposals in progress suggest a realignment of their status to that of the co-operative banks is desirable. Similar to the German savings banks especially in Alsace savings banks play an important role in the supply of financial services to their communities. In the rest of France their significance is less obvious.

Similarly connected to the local authorities are the Municipal credit savings institutions (*Caisses de credit municipal*). They were initially chartered in the 19th Century to combat the activity of usurers. They have the monopoly of undertaking pawn-broking business in France – they belong to the towns in which they are situated. In Paris alone they make 100,000 loans per year, with the lowest loan set at FF 200. They are non-profit making and although they cannot lend to businesses they can to associations. In this way they have managed to advance money to micro-business through intermediaries which are established as associations themselves.

In the UK the Trustee Savings Bank has been absorbed into the major banking groups, and the equivalent role has been played by building societies. From them there is a lesson for the savings banks and the co-operative banks. If they do not keep true to their roots in their products and services and ensure their customers know of this, they permit shareholder banks into their market and are seen to produce products and services equivalent to such banks.

(c) Co-operative and mutual banks

Co-operative banks in the form of mutuals, credit unions or religious banks intend to overcome the distinction between client and owner. Historically they were developed as a form of collective self-help. But with the increasing sophistication of financial services as well as the need for bigger entities to reach economies of scale most of them developed from mutuality into forms of ordinary share holding. At least their marketing and philosophy, as well as their special clients in rural areas keep them close to the idea of community investment. Co-operative banks in the three countries deliver a very different picture according to different regulatory environments. They range from small to big and from community linked to general banks or even to special purpose banks like the two German Eco-banks and the anthroposophical bank GLS.

(1) German Volksbanken

In Germany with 2,506 credit institutions at the end of 1996, some being in the top 10 in size, mutuals are seen as not very different from other banks in the light of preventing insufficient supply with the important exception of many institutions located in rural areas and being in strong relationship to the local customers. However, like the saving banks they offer little difference in the range of products available and could by no means be identified as a developer of appropriate products for unserved customer groups. After more than one hundred years the status “co-operative” seems no longer to have such an impact in defining and implementing social goals according to new social problems. In any event these undertakings still perceive themselves as being close to the community, advertising with the”Wir-Prinzip” (“We-principle”), a collective approach to banking.

New mutuals have been created which expressly try to develop models of social investment. But their quantitative importance is rather insignificant. Qualitatively however, they indicate that that a greater use of mutuality as a positive marketing tool alongside innovative product development may be a means of survival for their older siblings.

(2) French mutuals

The confederation of mutual credit institutions (*Credits mutuels*) are in fifth place in terms of size in France. 18 federations go into making this very much regionally based grouping. It is only in recent years that they have undertaken commercial rather than only consumer business. In 1996 FF 462m was directed socially. They are able to offer a tax efficient government promoted savings product called the "*livret bleu*".

There are thirty *Popular banks*, whose origins date from the Raiffeisen movement. In fact one can now perceive two strands within this grouping, in terms of whether or not they pay their managers. The popular banks specialise in the financing of small and medium sized firms.

For a long time the most important French bank, *Credit agricole* shares a similar history to the development of the *credits mutuals*, but with consistent state aid has witnessed strong growth.

(3) British mutuals

There is little co-operative banking in the UK, although the Co-operative Bank is a subsidiary of the largest consumer co-operative. It is primarily a retail bank but offers no special services directly to low income consumers or in the area of micro-finance. It has however a disproportionate customer base in the voluntary sector and among credit unions. In the UK the largest sector of social economy banking has been the building society sector.

The 1986 British Building Societies Act permitted these *mutual* institutions to engage in a wider range of financial service provision than their traditional role of home mortgage finance. This was seen as important because it was considered that the home mortgage market was reaching a mature stage. Although they are not able to provide services to undertakings, they are now able to offer the full range of basic banking services including extending overdraft facilities and offering unsecured personal loans.

The larger building societies have in the last 10 years turned their attention into becoming commercial banks reducing the share of the home mortgage market once served by mutuals from over 50% to closer to 25%. The process of de-mutualisation and conversion into banks is of significance for several reasons. Building societies in the public perception, demonstrated through consumer research, had had a reputation for higher customer care and delivering greater benefits in terms of interest rates on savings and loans than banks. With increase in size and product diversification some of the distinctions between the largest societies and banks had become blurred. De-mutualisation has led the remaining mutuals to re-examine their mutuality which may lead them once again to consider issues of social responsibility further as part of delivering a mutual benefit. Some building societies have remained very much local societies and providing services to low income consumers has been seen as part of their ethos. Examples of this were provided by Cambridge Building Society and Marsden Building Society.

(4) New co-operative bank movement

A new wave of mutual savings and loans organisations known as credit unions similar in origin to credit mutuels and Raiffeisen banks whose membership includes many low income consumers have to some extent revitalised the idea of mutuality. Credit unions are involved in both personal finance but also indirectly in small business lending through personal lending. The growth of this sector in the UK has been very slow by comparison with the USA, Canada and Ireland, but it is considered now to be at the same stage as building societies were at the turn of the 19th century. One in four US citizens are now members of credit unions and it is nearly one in two in Ireland. In the UK one in four local authorities are supporting the development of credit unions and legislative change to assist the growth of credit unions has occurred and is under further review. Credit unions in the UK may be a significant banking force in the longer term, but presently, their scope is dwarfed by the moneylending industry. Fewer than 200,000 people in the United Kingdom are members of credit unions whilst moneylending companies are serving between 2 and 3 million people.

In Germany and France the new co-operative banking initiatives are not primarily directed towards personal customers, but are active in the field of micro-credit and in lending to voluntary organisations and for environmental businesses. Quantitatively, their reach is limited, but qualitatively, they demonstrate innovative approaches to some micro-business finance issues and into funding business and organisations for sustainable development. The Dutch bank Triodos which has branches in Belgium, UK and Germany concentrates solely on social economy financing. It is active in financing the not-for-profit sector and in some micro-credit financing. It is a good example of how social economy banking can provide reasonable rates of return for a bank. It has reached a size where RaboBank considers it effective to make an investment in a bond issue of the bank, for investment purposes for some of the funds it received under the Dutch eco enterprise savings scheme, but also for strategic reasons to understand the lessons of social economy banking.

(d) Non-banks

Other independent social economy finance organisations without bank status are particularly active in France and the UK where they supply or direct funds into social areas either as principals or intermediaries.

Article 11 of the *Loi bancaire* 1984 evidences a legislative desire to tolerate marginal lending activity for social goals, *inter familia* when these organisations are working together and without recourse to external borrowed funds. In fact this provision has been interpreted particularly in favour of such activity since the beginning of the 1990s by the banking regulation committee, even allowing one organisation, ADIE to lend money which is not its own. Foundation France Active has also been permitted to guarantee loans made by mainstream banks to employment creating business start-ups.

In France, ARGO, a non-profit mutual guarantee society has enjoyed limited success in a rather small way in increasing its members seasonal economic stability and negotiating position with banks by joining forces.

France Initiative Reseau, a non-profit organisation undertakes micro-lending with a network of 60 access points. The source of the funds is largely public although there are some charitable donations from large companies. Some of the lending has now been guaranteed by SOFARIS and the failure rate of supported businesses is only 20%, comparing favourable with the 50% previously cited. It is significant that SOFARIS has now been employed to advance job creation initiatives in that this task has been handed over to professionals and that public money is used only to encourage bank lending rather than eclipsing their decision-making expertise.

The Fondation Nord Entreprendre is a private fund established by a rich family, essentially as a philanthropic gesture but also to promote entrepreneurship. They make loans which are interest free and require no guarantees.

L'Association pour le Droit a L'Initiative Economique (ADIE) was established in 1989, inspired by the activities of the Grameen bank in Bangladesh, but implementing its own procedures. Working as an intermediary, ADIE absorbs the additional costs which mainstream banks would otherwise incur in making micro-loans but this costs the organisation in the region of FF 10,000 for putting a loan of FF 20,000 in place.

La Nouvelle Economie Fraternelle is a co-operative financial services company linked to the Caisse Centrale de Credit Cooperatif,. Although not a bank but on a status near a bank and under control of central French coop bank, in 1994 NEF made a public offer of securities, raising funds from private persons wishing to invest their money in a vehicle designed to further certain social goals. What characterises its lending is the taking of numerous personal guarantees, thus exerting social pressure on the entrepreneur to be successful, an important reason for the success of many start-ups. NEF has been one of the first organisations to take advantage of Fonds Commun de Placement commitments. It is an innovative organisation which requires further growth before reaching a financially self-sufficient and sustainable operation.

In the UK in a survey conducted by the authors of the country report it was established that there was now £1.027 billion available or being invested in non-bank socially directed investment in the U.K. with the largest amount, almost £1 billion invested in social housing. Whilst social housing has taken a lead in the amount of funds being directed towards social investment, other purposes for which it has been directed include charities, and micro business. (credit unions were outside of the scope of this survey).

Many of the smaller financial institutions of the social economy have been the subject of a study by EPICEA for the European Commission in 1997, which has provided profiles of many of them throughout Europe. In the UK two micro lenders were featured: the ICOF Group and the Prince of Wales Youth Business Trust (PYBT). ICOF specialises in lending to co-operatives and community enterprises, whilst PYBT specialises in lending to young people establishing their own businesses. PYBT was considered a good example of a micro lending technique using soft loans because of the high survival rate of its customers compared with mainstream banks, through the use of its business angel concept. It obtained its funds from state grants and corporate donations and therefore its long term sustainability was doubted. ICOF operated with different business support mechanisms and at a substantially lower scale of operation, but demonstrated that private investors in ICOF were able to receive their capital intact at the end of a ten year lending period provided that the loan was not a soft loan.

In the charity sphere two new charity finance institutions were profiled. The Local Investment Fund and the Charities Aid Foundation Social Investment Fund. The Local Investment Fund was an initiative of the voluntary sector which has received government funding and matched donations and loans from the private sector. It has received significant support from banks which consider it as a mechanism through which they can obtain more experience of lending to the charity sector, and particularly those charities engaged in urban regeneration. It is a fund for England only. The Local Investment Fund will need to ensure that it can provide a reasonable rate of return to its bank investors to ensure its long term survival. The Charities Aid Foundation Social Investment Fund is funded by private donations and interest free loans from private individuals. It also lends to charities and is considered as a tool for learning about investment and saving which may lead to a charity bank. It is also supported by secondments from some of the larger UK banks.

The importance of many of these initiatives is in the opportunity which it provides for the development and testing of innovative ways of financing of identifiable gaps in the banking services markets, at not particularly high costs for mainstream banks, through secondments, investment and donations.

3. Direct state involvement through subsidy and service provision

Three different techniques to improve sufficiency and appropriateness of financial services with direct state involvement can be found:

(a) improving the business environment

In Germany the State aims to improve the business environment for lending to small firms by providing, in each of the *Länder,* a guarantee company or guarantee bank. While they are independent and sometimes even organised as a private company, they can deliver their service thanks to a 60% counter-guarantee of the German state. The State shares the risk of lending and guaranteeing with the *Mittelstand*. The French SOFARIS guarantee system is a similar initiative but without the intermediary guarantee bank: SOFARIS offers counter-guarantees directly to the small firm lending bank. In the UK the Small Firms Loan Guarantee Scheme provides support on a national basis by way of guaranteeing a high percentage of bank's small business lending.

(b) offering bank services

Banking services seen as crucial for social development are sometimes supported by the State itself. This was made clear in the UK country report where, in 1994, 82 *soft loan* schemes existed with the support of local authorities and an additional 32 were identified in the research which had not been recorded by the previous data. Often these schemes were acting as lenders of last resort, stepping in after bank finance could not be obtained, some were used as leverage mechanisms to obtain bank finance or additional bank finance, and some were established with the support of a bank, or with funds from the European Commission. There was little uniformity in the conditions of the loans and interest rates varied from being zero interest to above base lending rates. The UK research suggested that there appeared to be little merit in offering loans at interest below market rate and that this in fact contributed to the unsustainability of the funds with less ability to provide for bad debts. In Germany such local authority schemes do not exist.

(c) Offering a subsidy

An alternative to offering banking services is supporting others who provide desirable services. There are two alternatives, namely (a) subsidising the providing organisation and (b) subsidising the consumer buying the product. The first was illustrated by the micro-lenders ADIE and Prince's Youth Business Trust: both organisations are only sustainable due to subsidies by public and private organisations who think that the service of providing micro-loans is worth supporting. The subsidy is given as a grant to the organisation and not for example as a provision dependent on the number of assisted loans. This can be differentiated in France from the French *Livret A* where the providing bank achieves a share of the public payment made on the *Livret A*. Compared to direct grants to the organisation the *Livret A* scheme is more goal specific.

The second alternative was illustrated by the German system of supporting home ownership. The consumer buys a savings product as a step to home ownership, *einen Bausparvertrag*, and receives tax relief on it. Unfortunately, many consumers will never get the opportunity to use this product for home ownership because of the high cost of housing. There is little incentive by the banks to improve this product for whom it is effectively a "state subsidised“ supply of customers.

4. Conclusion and Summary

The national reports have examined national banking systems to examine how banks approach a demand that does not stem from discernibly profitable clients but arises on a geographic or communal basis. In fact, a *region* does not demand nor does a *community* itself buy bank products. Nonetheless, we are able to evaluate how the supply of financial services to bank customers has affected the well-being of a region or community. It is legitimate to question how can such effects be ameliorated by somehow adding a collective element to each individual transaction, the market may be transformed into a more complex exchange mechanism into which an individual transaction and individual marketing efforts are embedded into policy requirements. The new aspect of the present research does not concern the deficit analysis but rather how such deficits may be overcome in the future. Traditional studies on poverty and social decline suffice in so far as the analysis gives sufficient information for the State to act as a compensatory agency. Social investment studies *deficits* in order that the mechanisms that produce such problems or ignore them in the business can be changed, provided with additional goals or developed into a form in which the regional and communal outcome is less likely to have adverse effects.

Although this approach may be completely new to traditional bankers the national reports reveal that such collective elements have always been part of the banking system, as demonstrated above and in detail in the country reports.

These elements, described in the country reports have a dual problem: Firstly, public ownership, customer ownership or national regulators were neither introduced for the purpose of coping with problems of discrimination in banking nor are they likely to provoke banking into a direction so that communities and regions may be developed in economic terms. Their contribution to social banking is unconscious and indirect, the effect of the achievement of other goals shared with social banking only coincidental to public policy. They do not guarantee social responsibility and are also difficult to use for such purposes if these goals are not openly incorporated into day to day operational policy.

The second problem is built on the first. Because social effects are not the primary goal of these structures, the inadequacy of the historical goals underlying the public or co-operative structure of these banks presently leads to a weakening of such forms of banking in all countries. Savings banks in Germany are under a high pressure of privatisation or at least adaptation to private banking structures including the quest to give up regional cartels. Coop banks are increasingly sold to the private sector or transformed into a form of a co-operative that resembles a share holding company rather than a consumer driven institution. The new EU banking system, with its principles of home country control and mutual recognition as well as the introduction of the EURO and a central bank for the whole EU weakens the political influence national governments may exercise on their banks. On the other hand, the first banking directive concentrates financial services, also in the UK, more in the hands of traditional banks making the development of alternatives more difficult in the future. The following three theses may be offered:

- A regional or communal approach is not at all absent to the tradition of banking in Europe.

- But such elements are more or less unconscious indirect effects of other policies and implications in the tradition which either through the globalisation of competition or through the new structure of the EU banking market are threatened or in constant decline.
- A new policy in banking has on the one hand to be European wide and on the other need to be directly focussed on the problems caused by the modern social needs of equal distribution of financial services to regions and communities in a competitive environment that shows significant trends of active discrimination to the detriment of a social economy.

The study of the US community reinvestment, which focuses directly on discrimination in modern and advanced financial markets and is applied over different states with different bank supervision and legislation, seems at least to be an enrichment of the European discussion which is necessary.

III. Community Reinvestment - A specific instrument against insufficient supply

The US regulatory environment for the majority of credit institutions including banks and thrifts makes these institutions' business activity particularly transparent in as much as they must disclose specific and detailed information about the geographical and economic profile of their customers vis-à-vis where they undertake business activity. Behind this regulation one may perceive a presumption that credit institutions should conduct their core business in a socially responsible way with particular regard to geographical impact. The law itself is very broad:

Community Reinvestment Act 1977 12 USC 2901

SECTION 804 - Financial Institutions; Evaluation

(a) In general. In connection with its examination of a financial institution, the appropriate Federal financial supervisory agency shall -

(1) *assess the institution's record of meeting the credit needs of its entire community, including low and moderate-income neighbourhoods, consistent with the safe and sound operation of such institution; and*

(2) *take such record into account in its evaluation of an application for a deposit facility by such institution.*

However, any such social responsibility is only *facilitated* through the law and the regulations prescribed under it. The regulations do not actually force institutions to be socially responsible, rather encourage them to be so because of the questions they ask. And the question of social responsibility is circumscribed by the principle of anti-discrimination, rather than any wider starting point such as, as some have argued, that credit institutions fulfil a *quasi*-public function.

The significance of the CRA for this EU social economy banking report is essentially to evaluate the possible merits of transposing similar legislation across the Atlantic. The CRA has achieved many of the goals seen as desirable for social economy organisations but rather than allowing these matters to be marginalised it is mainstream credit institutions which have been working and continue to work towards social economy goals. And there is not just one model to scrutinise, rather in the region of 18 with special provisions for small banks, large banks and metropolitan areas. And the success of the CRA is about what has been achieved thus far; it is submitted that however much development of CRA regulation may seem to have progressed in the *right* direction, it should not be assumed that the latest changes are the most desirable for our purposes. In fact, they may be seen as a compromise, dependant on the very particular balance of power relations between all concerned in the US.

Since 1992 the commercially sensitive information which the institutions must disclose has been entirely in the public domain, and from that point all financial service consumers, including federal and state government, have potentially been able to base their choice or preferment of institutions and products on *more* information. In any event, rather than simply *having* money in a bank, consumers (and regulators) are given information relating to what their money is *used* for.

In fact there have been three perceptible steps to CRA regulation

(i)	1977-1992	*secret* CRA disclosure
(ii)	1992-	*public* CRA disclosure
(iii)	1997-	*results* rather than *process* CRA regulation

It is important to note that the CRA came in the wake of the highly draconian Home Mortgage Disclosure Act which will have focussed the minds of US bankers in a very severe manner. And, it is submitted that following this juncture the need for and implementation of highly detailed regulation has diminished. Instead bankers increasingly have a *socially beneficial bottom-line* to aim for rather than a prescribed way to get there. The effect of post 1992 public disclosure cannot be underestimated.

The US regulatory environment makes sense of the market economy paradox that investors *en masse*, such as credit institutions or equally pension funds, may jeopardise factors such as regional economic prosperity or job security for the very people who contribute to them and live or work in those areas. It does this by giving consumers the information that illustrates this rather abstract relationship enabling them to see the connection. While it is a common assumption that the United States is among the most free market orientated economies, especially when compared to Europe, the qualification that private enterprise there is concomitantly expected to fill gaps that would otherwise be left by smaller government is perhaps less immediately obvious.

In fact, the US legislation with which this study is concerned stems from the philosophy that there is some sort of contract of reciprocal rights and obligations between private, shareholder owned credit institutions and the US taxpayer. In exchange for the latter guaranteeing the deposits of the former, these institutions have an obligation to extend credit and financial services in general to their entire communities in a non-discriminatory way, including those areas populated by low and moderate-income households and minorities.

Although the legislation is concerned with the general concept of an adequate provision of financial services, it is the extension of credit which is its focus, including within its scope the activities of both wholesale and retail banks although many credit–giving and financial services institutions are left outside the regulation.

Viewed from the EU banking regulatory environment, the US situation raises questions about the purpose of banking and financial service regulation beyond the questions of deposit protection, safe and sound operation and maintaining the integrity of payments systems. But again, this is not some broad social responsibility, based on a requirement that institutions undertake activity which cannot properly be described as business. Rather, it assumes that there are areas of profitable business activity which would otherwise be left unprovided for because of discrimination and prejudice. However, the question of anti-discrimination is especially problematic in this area because of the etymology of the word credit, *credere* in Latin meaning to trust. And trust is not always something which is easy to build when there are a variety of reasons mitigating against a positive credit authorisation. Some of these may be linked to income and repayments ratios or screening for financial responsibility (*legitimate*) and others linked with other factors such as pure area of residence (*illegitimate*). However, it may occur that illegitimate reasons can be concealed behind legitimate ones, consciously or sub-consciously, and this is an area fraught with difficulties - hence the element of subtle positive discrimination within the framework of the legislation to achieve results.

There is evidence that business undertaken in fulfilment of CRA obligations is actually profitable business according to standard bank accounting procedures, especially when there is some stagnation in higher income consumer markets. But of course, supporters of the principles behind the CRA may wish to redefine the concept of *profitable* both in terms of absolute and relative return on capital and in broader more long-term or even social utility senses, concepts which may sometimes appear more appropriate.

As will become apparent, the CRA has been heavily criticised from all sides but it is important to distinguish between the desired goals of the regulation, the principles behind the regulation and the regulation itself. However, rather than presenting the most up-to-date overview and analysis of the CRA, the aim of this chapter is to highlight all of the possibilities offered by the progression of USA regulations. This chapter may be somewhat confusing in the way it will switch back and forth from the CRA as it was before the new performance-regulations came into effect (in July 1997 for larger banks) and the pre-existing regulations. As will be seen, the new regulations aim to address the most commonly levelled complaints against the CRA as was, but clearly there has been no opportunity to assess this empirically, hence the problematic presentation.

The bank regulatory agencies adopted the new Community Reinvestment Act regulations in May 1995 and established a transition period for institutions to develop compliance procedures. In November 1995 the agencies issued new examination procedures which aimed to facilitate a common sense assessment, albeit stopping short of using a market share test. Data collection under the new regulations has been mandatory since January 1 1996, with new reporting requirements effective from January 1 1997. All institutions which had not already voluntarily elected to do so became subject to the new regulations as of July 1 1997.

1. Community Reinvestment Act prior to January 1996

(a) Technical Requirements

- Public notice posted in lobby
- Documentation of annual board action adopting CRA statement
- CRA public file which includes
  - CRA performance evaluation
  - Map of delineated community
  - CRA statement – adopted annually by the board
  - HMDA data (if applicable)
  - Written comments from the public

(b) CRA Performance Evaluation Criteria

Performance categories	**Assessment factors for each performance category**
Ascertainment of community credit needs	· Activities to ascertain community credit needs and to communicate available credit services · Board of Directors role in formulating policies and reviewing institution's CRA performance
Marketing and types of credit offered and extended	· Marketing and special credit-related programs to let communities know about available credit services · Housing, small business, small agriculture loans originated or purchased within the community · Institution's participation in government or subsidised programs for housing, small business, small farms
Geographic distribution of credit activities and record of opening and closing branches	· Geographic distribution of institution's credit extensions, applications and denials · Institution's record of opening and closing branches
Discrimination and other illegal credit practices	· Practices intended to discourage credit applications for credit offered · Evidence of discriminatory or other illegal credit practices
Community development	· Institution's participation in local community development and redevelopment programs · Impediments to institution's ability to meet credit needs – financial condition, size, legal impediments, local economic conditions, etc. · Other factors that may keep the institution from helping meet the communities' credit needs.

2.

Community Reinvestment regulation beginning January 1996

(a) Technical Requirements

- Public notice posted in lobby
- Public file which includes
  - CRA performance evaluation
  - Branch and service information
  - Map of Assessment Area
  - HMDA data (if applicable)
  - Loan data information (Large banks)
  - Description of efforts to improve performance (if rated less than satisfactory)
  - Written comments from the public

(b) CRA Performance Evaluation Criteria

Performance tests	**Performance standards**
Large bank: Lending test	· Number and amount of loans in assessment area · Geographic distribution of loans · Distribution of loans based on borrower characteristics · Community development loans · Innovative or flexible lending practices
Investment test	· Dollar amount of qualified investments · Innovativeness and complexity of qualified investments · Responsiveness to credit and community development needs · Degree to which investments are not made by private investors · Benefits to assessment area
Service test	· Distribution of branches and record of opening and closing branches · Availability and effectiveness of alternative systems for delivering bank services to low- and moderate-income people and geographies · Range of services provided · Extent of community development services provided · Innovativeness and responsiveness of community development services
Small bank: Lending test	· Loan to deposit ratio · Percentage of loans in the bank's assessment area · Record of lending to borrowers of different incomes and businesses and farms of different sizes · Geographic distribution of loans · Action taken in response to CRA complaints
Wholesale or limited purpose bank: Community development test	· Number and amount of community development loans, qualified investments, or community development services · Use of innovative or complex investments, community development loans or services and extent that they are not routinely provided by private investors
Strategic plan	· Responsiveness to credit and community development needs · Achievement of strategic plan goals

3. Conclusions for regulation

The CRA regulation also responds to the problems analysed for the European market. It is a good starting point for a new approach in bank regulation where banking is no longer evaluated only by safety and soundness towards its own customers or the stability of the currency, but monitored on its impact on a community, a city borough or a region.

20 years experience of the CRA could suggest that such concerns are much more developed in the United States. Indeed the opposite is true. In many Member States of the EU, the balanced economic and social development of regions has a constitutional foundation. In Germany for example, the regions are bound to support each other by constitutional law. This principle is equally present in the Treaty where the structural fund as well as different contributions are designed to compensate for structural inequalities throughout the EU. The true difference between the US system of affirmative action and the European system of redistribution lies in their respective private and public status. CRA is not an answer to the question of how to cope with inequalities in modern society as such. In this respect observers of the American social situation would have reason enough to think that Europeans have little to learn from the Americans. The question is whether the private sector contribution to anti-discrimination could be significantly more developed in Europe than it is until now.

In this respect the US example is indeed interesting. Just because equal distribution of economic and social opportunities is a generally accepted public good in Europe provided by States and the European Commission through subsidies and home State action, private efforts to support such policies are less developed than they could be. As it is generally assumed that public efforts will no longer suffice to counteract rising tendencies towards regional and social discrimination, Europeans have good reason to take a closer look at the US system of Community Reinvestment for elements which could be incorporated into an emerging European system of more private responsibility for the public good in general.

Two aspects have to kept separate: Firstly, mistakes that have been made in the US do not have to be copied in Europe and secondly, differences in the banking environment in both continents necessitate a tailored approach for the EU.

- The starting point of the CRA in the US, that is to develop community reinvestment performance only as between banks and their supervisory institutions has shown little effect (but may have given the banks sufficient time to comprehend the philosophy of the CRA and integrate its requirements into their reporting system). Reporting about social effects of banking must be public to be successful.
- Administrative rules defining precisely how social effects should be measured and demonstrated may lead to an inappropriate bureaucratic burden for banks and divert their attention from the purpose of the required action to its administrative requirements. Such bureaucratic rules may equally produce unnecessary hostility to the regulation itself. A regulation should therefore focus on the purpose of the new

1996/97 CRA approach leaving as much discretion as possible for its fulfilment to the banks itself.

- Negative sanctions for non compliance are certainly an important starting point for making banks respond to community reinvestment ideas. But banks should have the opportunity to develop more positive incentives through the use of social banking procedures in marketing, product design and public relation.
- Mere quantitative approaches such as the social distribution of products among customers have two important disadvantages: Firstly, the bureaucratic part of disclosure is maximised and secondly, data suggesting success may disguise inappropriate or bad products which diminish instead of improving economic opportunities in the long run.
- An important European contribution to the CRA could be the combination of minimum standards for the social acceptability of bank products (usury interest rate ceilings, control of costs in repayment default, rights to adaptation in difficult social situations etc.) with a general monitoring of access.
- The European market would equally have to consider the existing state owned banks, coop banks and specialised financial institutions with social purposes and give them preferential treatment if they can show that they emphasise community reinvestment more than the legislation requires.

C. RECOMMENDATIONS

I. Develop a legal basis for non-discrimination on social grounds

(1) A starting point is to acknowledge there is no robust principle of anti-discrimination, either on ethnic, geographical or social grounds informing the provision of financial services in any of the three EU countries. As the UK report noted there is a concept of the general good in the Second Banking Directive and the European Court has decided that this can cover the interests of consumers, the protection of workers, social order and other matters. However, this is not a universal responsibility using similar criteria applied evenly throughout the European Union as a requirement under which all banks must operate, rather each banking authority may establish what it considers to be in the general good and apply that within the boundaries of European law. This contrasts starkly with the USA position. With the globalisation of banking services creating European if not global banks it is submitted that in order to progress the principles of non-discrimination and universal equality of access to financial services it is likely that a legal basis must be developed both in administrative and private legal relations at a European level. The Banking Directives might be an appropriate scheme for such legal basis.

(2) In France and Germany, at the State level there is a principle of equal treatment whereas for private entities there is no equivalent. With a privatisation of public tasks it is assumed that the US anti-discrimination approach must gain grounds, particularly in areas as central as financial services. In the UK one can see the development of minimum standards of social responsibility among some of the utility companies in relation to the provision of basic services such as gas, electricity and telephone. In the latter case, British Telecom will soon be introducing a low cost service which permits incoming calls only and outgoing calls to emergency services only.

(3) Whether the goal of non-discrimination on social grounds ought to be achieved through legal non-discriminatory principles in the EU, as it has been in the USA, is queried considering the strength of social equality heritage of continental European countries and principles of existing non-discrimination in EU law. One lesson from the US CRA development could be that it makes less sense to focus on ethnic discrimination than on social discrimination. However, if the legal approach is not to be one of non-discriminatory principles, the question of how to enforce principles to *act in the general good* becomes a matter of administrative law.

(4) EU structural funds, in the same way as German federal arrangements, demonstrate a commitment to regional balance with regard to economic prosperity

and consequently social equality. The concept of this type of non-discrimination is thus already well-understood within the EU. The legal place for anti-discrimination regulations remains to be identified.

II. Flexible regulation allowing priority to private initiatives

(5) Whereas a robust commitment to achieving social goals through banking and its regulation is desired, any legislative instrument would, it is submitted, have to be of a preliminary nature, be very flexible and ultimately reflexive to market adaptation to principles of social responsibility.

(6) There is another lesson to be drawn when looking on the US CRA: not the procedure demanded by the regulators, but the effects of banks examining their social impact, and developing new strategies and products, has been demonstrated as successful. The force of regulators, fixed procedures and documentation requirements make the CRA inefficient and something of a last resort measure in its USA form. It is believed that in order to get credit institutions' attention to the subject of social responsibility, measures of that magnitude ought not to be required. However, it is important to ensure that at a national and at a European level appropriate regulatory bodies are given the responsibility of ensuring that there is an adequacy and effectiveness of financial services for low income consumers and for social purposes.

(7) It is desirable to achieve certain minimum standards in the provision of financial services such as equal access for all. There should not be cost penalties for low-income consumers. But beyond such minimum standards in, for example the areas of basic banking services, mortgage loans and small business finance, market forces should be allowed to direct activity.

(8) The UK report also questioned whether European Union funds should be used to support low interest loans instead of market rate loans. It also suggested that further work was necessary on the development of regional bonds which might be a financial instrument to provide matched funding for national and European projects requiring state funding.

(9) Whilst it may be appropriate to annex any legal measures on social responsibility to the Social Chapter where much of the social dimension of EU law is found, a *Recommendation* on the social responsibility of credit institutions setting out a European Code of Practice and a set of goals for Governments to aim towards may be more appropriate. Together with the Recommendation a review committee could be established to follow the implementation by Governments and private credit institutions of such proposals.

(10) If credit institutions are to have minimum standards of social responsibility then they should be motivated to show commitment for equal access to financial services. One possibility could be a *self regulated Code of Practice* defining a

basic banking service and covering responsibility for access, for quality and cost of financial services. A step in that direction was made by the European Savings Bank Association when they issued their statement of principles in 1996. There should also be structures for review of the implementation of such statements to see how progress is being made.

III. Social Transparency to compete for the good

(11) Transparency of these issues is highly desirable to allow the proper functioning of market mechanisms and it is imperative that information about the activities of credit institutions in respect of their social responsibilities should be in the public domain.

(12) Transparency in three areas seem to be necessary: *distribution, social effects and best practise of financial services.* A Code of Social Responsibility in Banking practice might be drawn up which sets out what such responsibilities might be and how they should be reported. It might include the proposal in the UK report that information on a geographic basis should be provided as part of an initiative to combat inadequacies of financial services, coupled with data from reports by banks to the committees which review breaches of Codes of Practice.

(13) In order to measure social effects quantitative and qualitative sociological studies could be undertaken on behalf of credit institutions and their associations, particularly to ascertain what were the effects of certain products on low income consumers. Best practice studies could be placed with relevant international bodies.

IV. Developing new products and extending opportunity

(14) It was shown in the country reports that there is potential to work efficiently against problems such as unemployment or social exclusion with appropriate financial services products. Some ideas were given but further development is only possible in co-operation with experts in credit institutions.

(15) Research for new products with socially beneficial effects could be fostered by the European Commission. Appropriate tools would be best practice studies; an internet database of case studies with relevant information from the media, the banking sector and academic research; and invitations to tender for new products and product developments.

(16) Creativity and Innovativeness of approach is to be fostered and much research into new financial products and services is necessary, both from credit institutions themselves and others, as well as EU institutions.

(17) Use should be made of the practical experience which can be in the social economy. Small financial institutions of that group in each country demonstrate

that there are opportunities for social economy banking. The longer and more established of such initiatives are moving towards or have reached both a sustainable level but also prudential levels which prove their viability. However, a significant impact can be made through growth and professionalism - mainstream banks and social economy banks could together build up strategic arrangements at an early stage and this may be a mutually beneficial and effective way of understanding future challenges. To develop this process, the organisation of a series of meetings might be arranged to explore their benchmarking potential.

(18) In addition, the EU Banking Directives need to remain sufficiently flexible to permit new social financial institutions to develop within appropriate prudential criteria. Further examination of this area is overdue.

V. Incentives

(19) It may be desirable to include incentives towards best practice, to publicise the most successful initiatives and to allow institutions themselves to evaluate what they undertake in this regard as much as possible. Some external and independent assessment may also be required to consolidate a robust framework. Subsidies are certainly to be considered in all areas where contamination of the credit institution business decision making process is avoided. In the example of commercial micro loans it is obvious that even best practice is not commercially sustainable and therefore subsidies are essential. However, the technique of subsidy should foster market creativity and striving for efficiency on the one hand while concentrating on that part of the business where the social responsibility leads to over average costs - in the case of the previous example, because of the high support involved.

(20) At a consumer level there is also room for considering what tax incentives might encourage bank customers to save and invest for social purposes and thereby provide specific funds for such purposes. Making transparent what money is used for by particular institutions can only encourage consumers to make informed decisions.