"A national network of independent local banks would benefit the UK..."

COMMUNITY CHEST

Duncan O'Leary

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As ever, all mistakes and omissions remain my own.

Duncan O'Leary
July 2015

Executive summary

The UK's economy is unbalanced in two important ways. First, it relies too much on debt-driven consumption, and not enough on business investment and exports. This damages productivity and leaves the wider economy vulnerable to shocks. Second, the UK has stark geographical imbalances, with a particular reliance on London to generate wealth.

This study highlights those geographical divides and examines the role of the financial system in overcoming them. Focusing on lending to small and medium-sized enterprises (SMEs), it finds that companies are more likely to be rejected for a loan in poorer regions of the country than elsewhere – with business owners in these areas more likely to have to inject their own money into businesses than those in wealthier areas. The study also shows how credit conditions for SMEs are less favourable in the UK than in several comparable countries in Europe.

The report examines the local banking models that operate in a number of other European economies. It argues that the specific remit of local banks to promote local economies – not to maximise returns to shareholders – enables them to increase lending to more credit-worthy SMEs. This is because lending to these SMEs can be profit-making, but not necessarily profitable enough to be attractive to shareholder-owned banks, which must generate high returns on their investments.

However, the report identifies a number of pitfalls to be avoided if local banking models are to be successful. Local banks may be created through legislation and the use of public money, but they must be operationally independent of government. Political interference should be avoided at all costs. There must also be structures that prevent these institutions from being bought or sold, to encourage a long-term approach. Local banks in Europe have prospered only when they have had strong governance arrangements – representing different local interests and bringing in expertise – and when they have avoided exposure to wholesale financial markets.

The report recommends that the British Business Bank should act as an investor in local banks in the UK, helping draw together a network of locally rooted institutions to challenge and support one another. These institutions would be based on the Sparkassen model in Germany. They would operate a 'dual bottom line' – to promote the local economy as well as turn a profit. With the help of the British Business Bank they would also lend 'counter-cyclically', helping enhance the resilience of local economies.

About the study

The research for the study involved the following elements:

- *Desk-based research*, bringing together the evidence base on SME lending in the UK, including the extent to which there is a structural problem with SME lending and the different patterns in SME lending across the country. This included analysis of data for *SME Finance Monitor*, a quarterly survey of SMEs, which provides data at a regional level. Through desk-based work, we also examined the evidence on the successes and failures of local banking models from around the world. This included studying the operational, financial and governance arrangements of these different models.

- *Case studies*, examining different local banking models emerging in the UK, from commercial models to social enterprises and the expansion of credit unions. This involved telephone interviews, discussion groups with local residents and further desk-based research examining public documents concerning the three institutions that we focused on. Specifically, we examined Cambridge & Counties Bank, Hampshire Community Bank and the Bank of Salford. These three initiatives are at different stages in their development.

- *Expert engagement*, involving ten semi-structured expert interviews, examining the prospects for local banking in the UK. In addition, Demos hosted four roundtable discussions with policy-makers and stakeholders from the private and voluntary sectors, including small business groups, banks and charities concerned with financial reform. In these discussions, we examined the evidence collected through the desk-based work and tested emerging recommendations.

The report

Chapter 1 examines arguments for 'rebalancing' the UK economy and progress to date. It identifies the political consensus in favour of 'rebalancing', so that there is less reliance on London to generate growth and more emphasis on business investment rather than personal debt. However, it notes the scale of the challenge – London and the South East are more productive, have lower unemployment rates and more SMEs than elsewhere in the country.

Chapter 2 explores the way SMEs in the UK access finance. It notes that business investment can be achieved through internal finance – organisations using their own resources or reinvesting profits – or through external finance. Where UK SMEs seek external finance, overwhelmingly they go to banks for loans. The chapter highlights that many small businesses in the UK are 'discouraged' from ever applying for loans. It also finds that although rejection rates for SME bank loans are lower in the UK than the EU average, they are much higher than some of the UK's key competitors.

Chapter 3 looks at regional patterns in UK bank lending to SMEs. Drawing on data from *SME Finance Monitor,* it shows how bank lending patterns vary around the country. The analysis shows that SMEs in the poorest areas are the most likely to be rejected for bank loans or overdrafts and most likely to say they have no option but to inject their own funds. This is likely to be linked to differences in the survival rates of businesses in these areas, as well as the ability of businesses to provide collateral to secure loans against.

Chapter 4 focuses on recent policy interventions in banking and SME finance. It examines recent reforms to the financial system, which have largely been designed to increase competition. We argue that these changes are necessary but not sufficient because shareholder-owned banks face structural difficulties in lending to SMEs. The Government has tacitly recognised this with the creation of the British Business Bank, which has a remit to increase SME lending, in addition to a number of individual schemes, such as Funding for Lending and the National Loan Guarantee Scheme. However, to date, the British Business Bank has largely replicated existing patterns in UK lending.

Chapter 5 details local banking models from other countries around the world. It examines the savings bank model of the German Sparkassen, the Spanish 'cajas', the Swiss cantonal banks and community-based banking in Australia. The chapter draws out the lessons from each of these different approaches. It highlights the strong governance arrangements of the Sparkassen, which complement their conservative approach to lending. It also identifies the value of the mutual guarantee scheme of the Sparkassen, which encourages banks in the network to support and scrutinise one another. The chapter identifies pitfalls to avoid, including the exposure of the 'cajas' to wholesale financial markets and political interference.

Chapter 6 identifies local banking initiatives within the UK. It looks at three initiatives in particular, which are at different stages of development and have adopted different models. Cambridge & Counties Bank is a new, challenger bank, specialising in lending to SMEs within the UK. It takes deposits from households and SMEs, and is set up to make loans of between £50,000 and £1 million to SMEs with a turnover of under £25 million. Local First is a community interest company, which plans to launch a local bank in Hampshire, provisionally entitled Hampshire Community Bank. The bank is to be based on the Sparkassen model adopting an explicit mission to create a strong and sustainable local economy. The Bank of Salford is an initiative led by the mayor of Salford, Ian Stewart, to create a local lending institution for the area. One possible home for the Bank of Salford is the Salford Credit Union, which has around 4,000 members.

Chapter 7 concludes that the UK would benefit from having a national network of independent local banks and sets out policy proposals for bringing this about. The banks could operate at a similar scale to the Sparkassen in Germany where, on average, each local bank serves around 200,000 people. The banks would be mission-driven: profit-making but not profit-maximising, aiming to promote the economic health and resilience of the areas they operated in. The banks would be part of a network that provided mutual challenge and support, including financial support where necessary. The British Business Bank would act as an investor in this network of independent institutions, but would insist on strong governance arrangements to protect against political interference and ensure a prudent, long-term approach.

The report concludes with recommendations for further research. These include proposals for qualitative work to understand more about SME 'discouragement' and loan rejection, financial modelling for a mutual guarantee scheme to match the Sparkassen, and engagement with pension funds and others to examine options for attracting more finance to local banks.

Introduction

The UK's economy is unbalanced in two important ways. First, it relies too much on debt-fuelled consumption, and not enough on business investment and exports. By common consent, this model of growth damages productivity and leaves the wider economy vulnerable to shocks. Second, the UK has stark geographical imbalances. There is a broad north–south divide, with a particular dependence on London for wealth creation. This report explores whether local banking might help address either or both of these two problems: helping facilitate business investment and generate growth around the country.

The report also examines whether local banks might help create local economies more resilient to shocks. Following the financial crisis, the UK economy entered a downward spiral. Contractions in credit negatively affected business performance, which in turn contributed to further credit contraction. This effect was mitigated in some other European countries where local banks played an important role in sustaining SME lending, improving the resilience of local businesses and national economies.

The fundamental argument of the report is that while measures to produce greater competition in the banking system are welcome, the UK needs *different types* of banks, not just more banks. This is because shareholder-owned banks, which must produce high returns on capital, find SME lending expensive and difficult to justify beyond a certain level. SME lending can be profitable, but not as profitable as other forms of investment, such as mortgage lending. Firms that are expensive for banks to assess are not given loans, even if they are credit-worthy. This partly explains the SME funding gap.

This is a structural problem, likely to be exacerbated by recent regulatory changes. The credit crisis demonstrated the need for banks to protect themselves better against risk –

at least until they can be allowed to fail without claiming money from the taxpayer. The new Basel III regulations stipulate that banks must hold more capital in general – and for SME lending in particular. Therefore, a form of lending that already faces pressures on profitability is likely to become less, not more, attractive in the coming years. Local banks could offer a way of squaring the circle, by helping extend credit to SMEs without the need to undo the new regulations.

Shareholder-owned banks will retain a vital role in the UK economy, but the UK would benefit from greater diversity in its banking sector. Unlike other industries, it matters not just that the sector is profitable and successful on its own terms, but also that it is able to provide credit to credit-worthy businesses in the rest of the economy. Different models of banks would help extend lending further in the SME lending market, benefiting local areas and the economy as a whole.

In other countries, such as Germany and Switzerland, there is greater diversity in banking. In addition to commercial banks, there are banks that are not shareholder-owned. These banks are profit-making but not profit-maximising. They operate with a dual bottom line: to turn a profit *and* to promote the local economy. Their dual bottom line is the reason why these local banks are more disposed towards SME lending. Because they have no obligation to maximise returns on investment, SME lending helps them fulfil their remit to promote local economies. The fact that these banks do not need to provide dividends to shareholders also helps improve rates of return to depositors.

Local banks therefore fill an important niche in many countries. They provide what the Federation of Small Businesses (FSB) describes as 'plain vanilla lending':[1] loans that are low risk and give a low return to the lender, producing profits which are steady but unspectacular. Local banks also provide loans to businesses, whose credit-worthiness may be expensive to assess, but are credit-worthy nonetheless.

The key point is not that local banks have a higher *risk* appetite; it is that they have a lower *profit* requirement. Paradoxically, this can also make local banks safer than commercial banks, whose appetite for higher profitability often leads them to produce much more volatile results over time. Local banks tend to have a steady performance, with more consistent returns on capital and a more conservative approach to holding capital reserves.

As a consequence, local banks have also been able to bolster the economic resilience of areas in some cases. Because the Sparkassen survived the financial crisis in reasonable health, for example, they were able to work with the Kreditanstalt für Wiederaufbau (KfW), the government-owned development bank in Germany, to extend credit to businesses in their areas. This ability to lend 'counter-cyclically' contributed towards more resilient local economies being established and a quick return to growth for the Germany economy as a whole. In contrast, commercial banks, which had pursued more aggressive strategies before the crisis, had little option to focus on repairing their balance sheets, rather than lending to SMEs in its aftermath.

The report argues that the UK would benefit from having a network of local institutions with a specific remit to lend to SMEs. This network would complement the work of commercial banks, by extending credit lines to credit-worthy businesses and lending 'counter-cyclically' when commercial banks retrench. There are several local initiatives in the UK aimed at establishing local banks which might be supported and built on.

However, the UK needs to learn the right lessons from local banks in Europe and beyond. The German Sparkassen represent a model to be emulated, with their dual bottom line, strong governance arrangements and networked structure. However, the Spanish 'cajas' demonstrate what can go wrong with the model if these features are not in place – especially when local banks suffer from either political interference or exposure to wholesale financial markets.

The report concludes that a network of local banks should be built in the UK from the ground up. Neither central nor local governments should seek to create or own local banks. Instead, the British Business Bank should act as an investor in independent, local initiatives. In doing so, it should help bring different, independent organisations together as part of a shared network, to support and scrutinise one another, while benefiting from economies of scale.

The report is structured as follows:

- Chapter 1 examines arguments for 'rebalancing' the UK economy – and progress to date.
- Chapter 2 explores the way SMEs in the UK access finance.
- Chapter 3 looks at regional patterns in UK bank lending to SMEs.
- Chapter 4 focuses on recent policy interventions in banking and SME finance.
- Chapter 5 details local banking models from other countries around the world.
- Chapter 6 identifies local banking initiatives within the UK.
- Chapter 7 concludes that the UK would benefit from having a national network of independent local banks and sets out policy proposals for bringing this about.

1 Imbalances

There is broad political consensus that the UK economy requires 'rebalancing'. This language has been adopted by each of the major political parties, but the idea was given perhaps its clearest articulation in 2010 by the then shadow chancellor, George Osborne. In his Mais lecture, entitled 'A new economic model', Osborne said the challenge was

...to move away from an economic model that was based on unsustainable private and public debt. And we have to move to a new model of economic growth that is rooted in more investment, more savings and higher exports.[2]

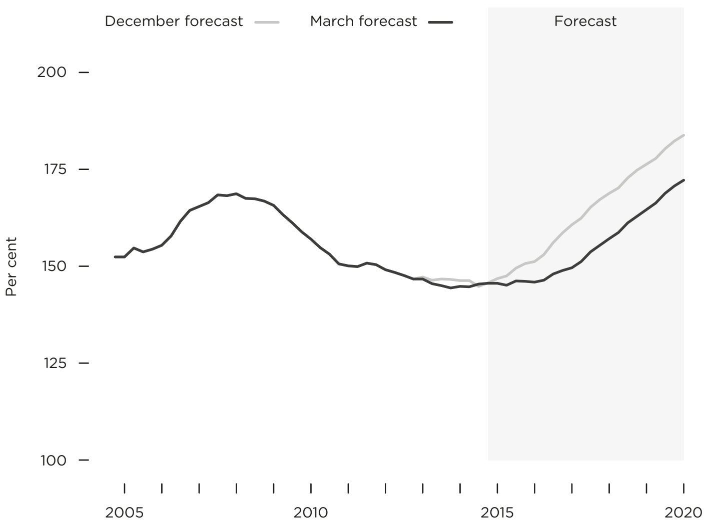
Behind this idea are two intuitions: first, that business investment is a key driver of greater productivity, the fundamental determinant of a society's standard of living in the long run. Investment enables firms to acquire new equipment, train their staff to higher levels and experiment with new products and ways of working.[3] Second, high levels of consumer debt can maintain living standards in the short term but risk leaving households vulnerable to economic shocks and the economy more fragile in the long run. This broad view has been echoed beyond politics, for example by the Confederation of British Industry (CBI), which has emphasised 'resurrecting business investment and net trade as the key drivers of growth'.[4]

Is his Mais lecture Osborne also emphasised the need to 'raise the private sector's share of the economy in all regions of the country, especially outside London and the South East'. Returning to the theme in his first speech following the 2015 election, the chancellor argued, *We should not passively accept that, compared to the rest of our country, the relative economic decline of the north of England is inevitable. We can reverse it – and create a balanced, more healthy economy for working people across our United Kingdom.*[5]

The Labour party has made similar arguments, with figures like Jon Cruddas and Lord Adonis calling for more devolution to cities, allowing different parts of the country to build on their unique strengths.[6]

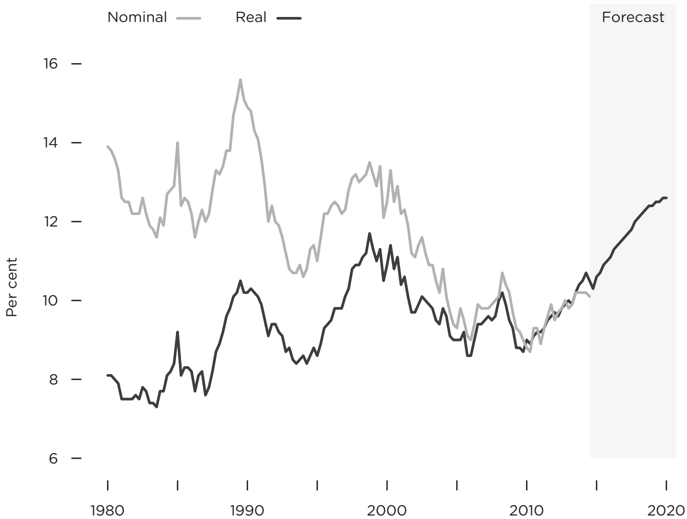
Despite this broad consensus on 'rebalancing', however, there remain considerable challenges. Official figures show that while household debt has fallen steadily since 2008, it is forecast to rise again from 2015,[7] reaching pre-crisis levels by 2019 (figure 1).

Figure 1 **Household gross debt to income in the UK, 2005–2020**



Source: OBR, *Economic and Fiscal Outlook*

Figure 2 **Business investment as a share of GDP in the UK, 1980–2020**

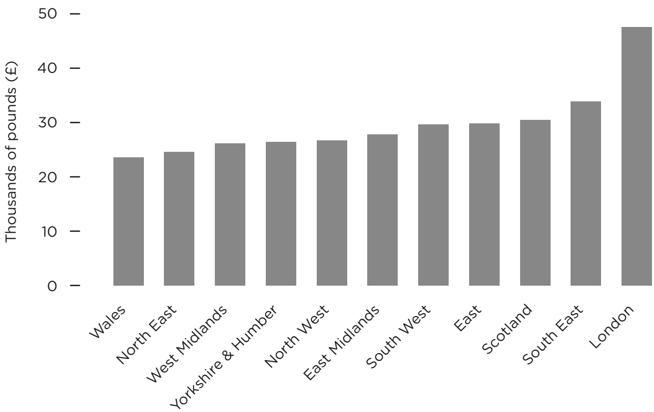


Source: OBR, *Economic and Fiscal Outlook*

Meanwhile, business investment is picking up[8] (figure 2) but remains low by international standards. According to the International Monetary Fund (IMF), the UK ranks 156th out of the 173 countries for business investment as a proportion of gross domestic product (GDP).[9] On this measure, the only advanced economies below the UK are Malta, Iceland, Ireland, Cyprus and Greece.

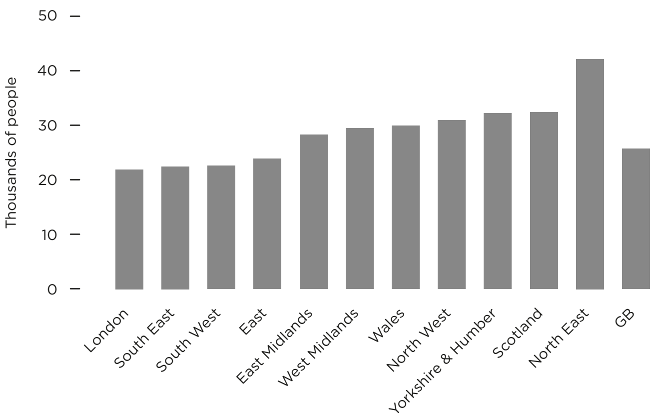
Long-standing regional imbalances also still persist. On a measure of gross value added (GVA) per head,[10] which captures the value of goods and services produced in an area, London and the South East comfortably outperform the rest of the UK (figure 3), with Wales and large parts of the North of England lagging considerably behind. Wealth creation remains unbalanced across the country.

Figure 3 **Regional GVA per person in Wales, English regions and Scotland, 2013**



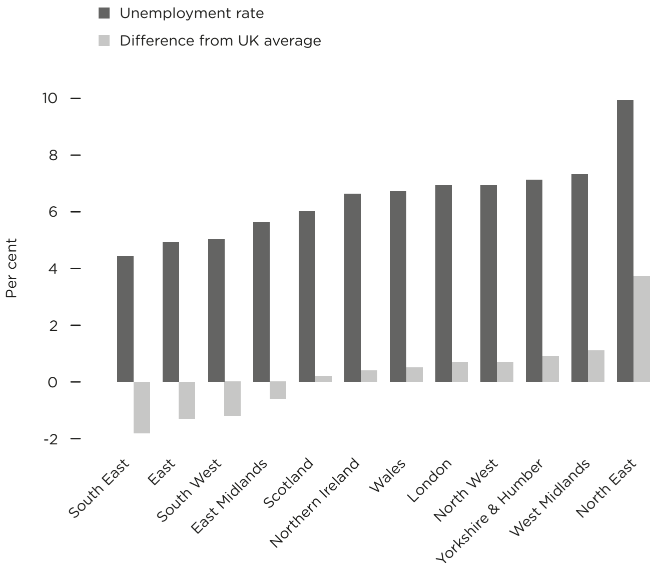
Source: ONS, *Regional Economic Indicators*

Figure 4 **The number of working age people per SME in Wales, English regions and Scotland, 2014**



Source: ONS, 'UK population estimates 2013', and BBA, 'Bank support for SMEs'[11]

Figure 5 **The unemployment rate in Scotland, Wales and some English regions and difference from UK average unemployment, May–July 2014**



Source: ONS, 'Regional labour market, July 2014'[12]

This geographical imbalance in wealth creation is reflected in the number of small businesses in each area (figure 4). For example, there is one SME for every 42 people in the North East, compared with one SME for every 23 people in the South East and the South West. This greater density of businesses in the South suggests it has a healthier, more thriving economy than the North East, as well as Yorkshire & Humber and the North West. Similarly, unemployment figures are higher in the North East and Yorkshire & Humber, the West Midlands and the North West than in London, the South East and the South West (figure 5).

These regional imbalances in the UK are starker than is the case in many comparable economies. For example, in Germany all eight of the biggest cities outside Berlin outperform the country in GDP per capita – they are more productive than the country as a whole. In France, three of the eight biggest cities outperform the national average on the same measure, while none fall significantly below it. But in England, only London and Bristol outperform the national average.[13] As Tristram Hunt put it in a recent speech to Demos, 'We are one of the most centralised countries in the world. Practically nowhere else in the world [do] the capitals of finance, culture, commerce, politics, media, fashion and sport all reside in one city.'[14]

Such imbalances leave areas dependent on the political will of the rest of the country to keep living standards high through redistributive policies, rather than banking on their own economic performance. It is this which the chancellor and others are aiming to correct, when they describe the need to 'raise the private sector's share' in more parts of the country. The aim is to help areas produce more wealth of their own, while becoming resilient to financial shocks in the future. The next chapter turns to how businesses access finance to sustain themselves and grow.

2 Business finance

Moving towards an economic model based on higher business investment depends on many things coming together. In his Mais lecture George Osborne pointed towards fiscal and monetary policy, tax regimes and the performance of the UK's education and welfare systems, among other factors. The role of government, he argued, is to create the conditions under which businesses can operate efficiently, thereby creating more attractive opportunities for investment. However, this still leaves the question of how exactly businesses will finance investment. This chapter addresses that question.

Business finance

Business investment can be achieved through internal finance – organisations using their own resources or reinvesting profits – or through external finance. There are two broad categories of external finance: debt finance, where investors lend money that must be paid back, and equity finance, where investors take a stake in the business itself. However, some financial products represent a hybrid of debt and equity.

According to the government, around half of businesses use external finance at some stage, with around 20 per cent of SME employers (those with at least one employee, excluding the owner) seeking finance at any one time.[15] Debt finance is the most widely used form of external finance, with equity finance largely reserved for either large companies, which can access the capital markets, or companies judged to have high growth potential, which turn to venture capital.

The latest figures published by the government show that, of those seeking external finance, three-quarters of SME employers seek debt finance (40 per cent seek loans and 35 per cent seek overdrafts). Only around 1–2 per cent seeking finance want equity finance.[16] Other types of finance sought include grants (9 per cent), leasing or hire purchase (8 per cent) and mortgaging property (6 per cent) and loans from family (3 per cent). Banks are still the primary sources of finance received by SME employers. Half of SMEs that use at least one form of external finance most commonly use bank funding.[17] In the last year, 28 per cent of all SMEs have used an overdraft and 11 per cent have used a bank loan. In short, where UK SMEs seek external finance overwhelmingly they go to banks for loans.

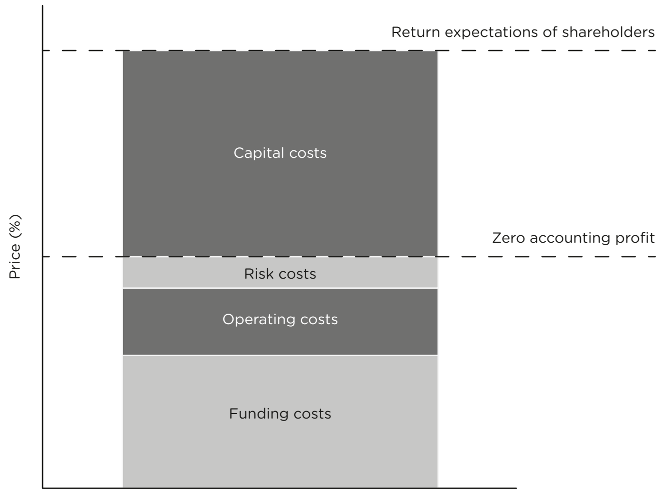
The lending hurdle

In November 2013 the Royal Bank of Scotland (RBS) published an independent review of RBS lending, conducted by Sir Andrew Large.[18] The review set out the four factors that determine the costs of bank lending to businesses:

- *funding costs*: the cost at which banks can secure funds to lend to businesses, for example from deposits from customers
- *operating costs*: the costs of running a business, including staff, buildings and equipment
- *risk costs*: the loss that the bank expects to make through companies defaulting on loans
- *return on capital*: the return on investment expected from shareholders and specified by regulators as part of the framework for determining how much capital banks must hold[19]

The Large Report explained that these four costs combine to create a ‘hurdle rate’ of return on investment, which banks must achieve to satisfy shareholders. This hurdle rate is illustrated in figure 6.

Figure 6 **The costs of bank lending to businesses**



Source: Large, *RBS Independent Lending Review*

SME lending

Since 2011 data on lending to SMEs have been collected through the *SME Finance Monitor*, which conducts 5,000 interviews per quarter with SMEs, defined as organisations with no more than 249 employees. This definition includes sole traders who have established their own companies.

Data from the most recent annual report of the *SME Finance Monitor* show that 2 per cent of SMEs applied for a new bank loan in 2013, while a further 1 per cent sought to renew an existing bank loan.[20] Meanwhile, 3 per cent of SMEs applied for a bank overdraft, while 3 per cent sought to renew a bank overdraft.[21] In 2013 there were 4.9 million SMEs in the UK, suggesting that around 147,000 SMEs either applied for or sought to renew a bank loan that year, while 294,000 businesses either applied for or sought to renew an overdraft.

Over a two-year period (Q1 2012 – Q4 2013), 42 per cent of SMEs applying for a bank loan or loan renewal received what they were looking for, while over a third (35 per cent) were rejected, receiving no facility. Over the same period 59 per cent of SMEs applying for a bank overdraft, or extension, received what they were looking for while around a quarter (24 per cent) received no facility.[22] Table 1 sets out the proportion and approximate totals of SMEs accepted and rejected for loans and overdrafts in the UK in 2013.

Table 1 **The proportion and approximate totals of UK SMEs accepted and rejected for loans and overdrafts in the UK, 2013**

Applied Q1 2012 – Q4 2013 SMEs seeking new or renewal loan facility	SME loan applicants 2013/14	Approx. total SME loan applications in 2013	SME overdraft applicants 2013/14	Approx. total SME overdraft applications in 2013
Offered what wanted and took it	42%	61,740	59%	173,460
Took loan after issues	15%	22,050	14%	24,284
Have loan (any)	57%	83,790	73%	126,626
Took another form of funding	8%	11,760	3%	5,203
No facility	35%	51,450	24%	41,630

Source: BDRC Continental, *SME Finance Monitor 2013*, and BIS, 'Business population estimates for the UK and regions 2013'[23]

The *SME Finance Monitor* also collects data on SME 'discouragement': those businesses that never make a formal application for a bank loan because they believe they would be rejected. The *SME Finance Monitor* identifies discouraged SMEs as a subset of 'would-be seekers' – SMEs that would ideally have liked to apply for loan or overdraft funding in the previous 12 months. (Some SMEs do not borrow for other reasons, such as finding borrowing unattractive in principle.)

In 2013 6 per cent of SMEs were 'would-be seekers'.[24] Approaching half (43 per cent) of this group or approximately 126,420 SMEs – were discouraged in 2013.[25] Of those that were discouraged, 12 per cent were directly discouraged – they were put off from making an application by the bank; 31 per cent were indirectly discouraged, simply choosing not to make an application through fear of being rejected (table 2).

Table 2 **The number of UK SMEs that never formally applied for a bank loan because they expected to be rejected, 2012–13**

Applied Q1 2012 – Q4 2013 SMEs seeking new or renewal loan facility	SME 'would-be seekers'	All SMEs (UK)	Approx total SMEs (UK)
Discouraged (any)	43%	2.6%	127,400
– Direct (put off by bank)	12%	0.7%	34,300
– Indirect (thought I would be turned down)	31%	1.9%	93,100
Issues with process of borrowing	35%	2.1%	102,900
Issues with principle of borrowing	8%	0.5%	24,500
Economic climate	5%	0.3%	14,700

Source: BDRC Continental, *SME Finance Monitor 2013*, and BIS, 'Business population estimates for the UK and regions 2013'

International comparisons

To gain perspective on these numbers, it is useful to compare the experience of SMEs in the UK with that of SMEs in other comparable countries. There is no single dataset which provides figures that are directly comparable to the *SME Finance Monitor*, but the European Bank's survey of SMEs' access to finance provides an opportunity to make international comparisons.

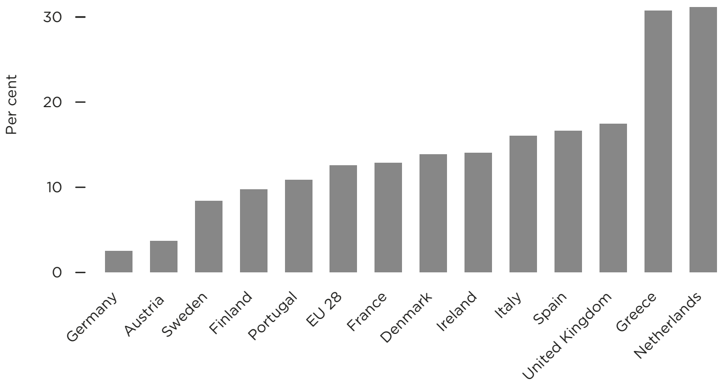
This survey covers SME employers – those with at least one employee, excluding the owner. (This explains why the percentages that it produces are higher than those produced by *SME Finance Monitor*, which covers all SMEs in the UK, including sole traders.) Rejection rates for SME employers in the UK are higher than the EU average and considerably higher than some countries such as Germany and Austria (figure 7).[26] Discouragement rates are lower for the UK than the EU as a whole, but higher than several key competitors, including Germany and Austria (figure 8).[27] These international comparisons show that there are less favourable credit conditions in the UK than in a number of other comparable economies.

Structural problems

There have been several attempts to estimate the size of the SME finance gap in the UK. In 2013 the Department for Business, Innovation and Skills commissioned analysis from Deloitte LLP, which estimated there was a gap of £22 billion in SME finance. This gap was defined as the difference 'between the amount of finance available to SMEs and what they actually need'.[28] The 2014 Breedon report, also commissioned by the government, estimated the SME finance gap to be between £26 billion and £59 billion.[29] This estimate was based on analysis comparing past trends – in corporate lending and GDP growth – with economic forecasts, in order to estimate the credit requirements of businesses in the future.[30]

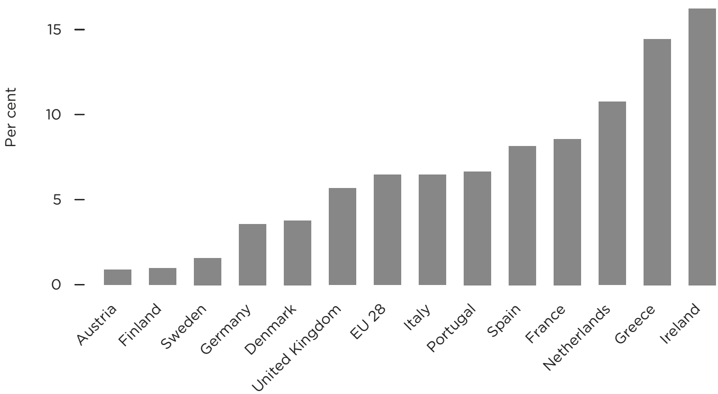
The Breedon report argued that this gap exists partly because there is a structural market failure in the provision of debt finance to SMEs, and that this arises partly because there are fixed costs to assessing the credit-worthiness of a business, regardless of its size. SMEs tend to require small loans[31] (the median loan sought by SMEs is £10,000 and the median overdraft sought £5,000[32]). This makes lending to small businesses less profitable than lending to larger organisations, for which the costs of assessing credit-worthiness do not differ substantially, but the loan made is likely to be bigger.[33]

Figure 7 **Rejection rates for SME employers applying for finance in some EU countries, 2013**



Source: EC, *2013 SMEs' Access to Finance Survey*

Figure 8 **Proportion of SMEs in some EU countries and EU28 that did not apply for finance because of possible rejection, 2013**



Source: EC, *2013 SMEs' Access to Finance Survey*

The Breedon report also noted that businesses without a track record are particularly hard for banks to assess. Banks therefore seek reassurance when lending to these companies through the provision of collateral to secure against a loan. Breedon argued that this process produces a market failure, in which lending is skewed towards businesses which have the available collateral, rather than businesses which are most viable.[34]

Small business lending also suffers by comparison with mortgage lending because mortgage lending involves fewer variables – types of house and household income do not vary that much – whereas SMEs vary enormously in their business models. Therefore SME lending is more resource intensive than mortgage lending as assessing credit-worthiness requires much more time and effort.[35]

These factors – in particular the high fixed costs of assessing the credit-worthiness of SMEs – bring down the profit margin of SME lending, making it harder for banks to achieve hurdle-rate returns. Importantly, this does not mean that firms are not credit-worthy, or that SME lending cannot be profitable – but hurdle-rate returns demand that loans are not just profitable, but *profitable enough*.

Changes to regulatory arrangements may be about to exacerbate these issues. There are several new capital requirements, introduced as a consequence of Basel III[36] and designed to make banks safer:

- Banks are required to hold more capital than at any time in recent history, reducing their ability to lend.

- Banks must retain more capital for SME lending than mortgages, making SME lending less attractive than mortgage lending, unless the returns (interest rate charged) are very high. (Banks must hold approximately five times more capital when they issue a loan to a business than they do when they issue a mortgage on a house.) This was recognised in the Breedon report.[37]

- Secured SME lending has lower capital requirements than unsecured lending, accentuating the point made by Breedon that loans may follow collateral rather than the growth potential of businesses.

This combination of factors – lower profitability in SME lending, the need for hurdle-rate returns in commercial banks, and new regulatory arrangements – combine to reduce the attractiveness of SME lending to banks.

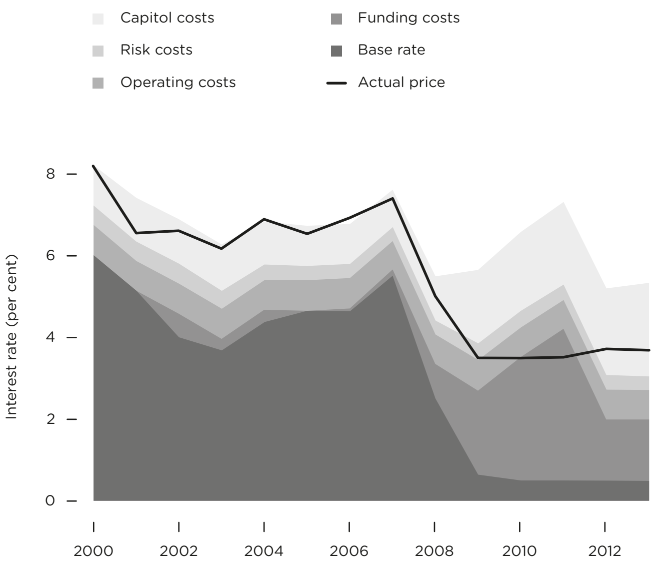
Below the hurdle

The analysis conducted for the Large review found the returns from recent SME lending to be falling below the required 'hurdle rate' for the bank. The black line in figure 9, taken from the Large review, shows the actual price of bank loans compared with the hurdle rate. As the report puts it: 'Interest payments on SME loans, as a stand-alone product, are not generating a sufficient return to meet the requirements/expectations of investors.'[38] This conclusion was echoed in a recent report by the Competition and Markets Authority (CMA) and Financial Conduct Authority (FCA).[39]

There are two important things to note about the analysis depicted in figure 9. First, it dealt with SME loans *as stand-alone products*, but noted that such loans can be gateway products to other more profitable transactions. The review noted that 'charges for other services (such as transaction services) typically mean that banks make a hurdle rate of return on their overall SME banking operations',[40] so banks may be able to absorb the cost of loans below hurdle rates if they are able to achieve higher returns on other products sold to the same SMEs as a consequence.

However, there is a second important point to bear in mind: the line in figure 9 represents *loans that have been made*. The lending gap analysis performed by Breedon and others implies that there is more viable lending that *could* be taking place, but which is even less attractive to banks, even when used as a gateway product.

Figure 9 **The average economics of UK SME lending for banks, 2000–13**



Source: Large, *RBS Independent Lending Review*

Analysts at KPMG predict that in coming years banks will struggle to deliver returns in excess of the average cost of equity of 12 per cent.[41] They believe this will lead to banks 'sharpening their strategy on which products to sell, depending on the levels of capital they consume and the returns they make'.[42] The analysis above suggests that this is likely to put more pressure on SME lending, not less.

3 Regional patterns in lending

Regional differences

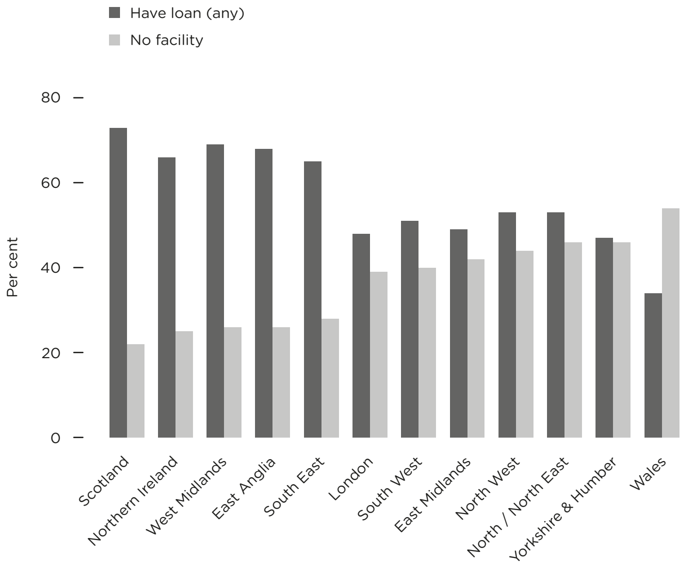
The last chapter highlighted that credit conditions are less favourable in the UK than in competitor countries such as Germany and Austria. This chapter explores the extent to which there are differences across the UK.

Data from *SME Finance Monitor* allow comparisons to be made on access to finance at a regional level. As figure 10 shows, rejection rates for bank loans (those SMEs that receive 'no facility') are highest in Wales, Yorkshire & Humber, the North East and the North West. Of these, the North West and Yorkshire & Humber are the two areas with the lowest GVA per head and the highest unemployment rates, as described in chapter 1. SMEs in the poorest areas are the most likely to be rejected for bank loans or overdrafts.

In many of the same areas where rejection rates are the highest, SME owners are also more likely than average to have no choice but to inject personal funds into the business. The North East, Yorkshire & Humber and the North West are the areas of England where SME owners are most likely to inject their own funds into their businesses (figure 11). This harms the economic resilience of those areas, by limiting the capital available to firms either to invest in the future or to overcome periods of difficulty.

Why do these regional differences in lending exist? Official figures show that, with the exception of London, both three- and five-year survival rates tend to be lower in the areas with the highest loan rejection rates, such as Yorkshire and the North East (figure 12). Such failure rates increase the risk costs for banks, squeezing profit margins. As a result, weak local economies can damage the prospects for local businesses. Poor prospects then limit the ability of businesses to access lending and make investments. This then weakens the local economy further, producing a vicious cycle.

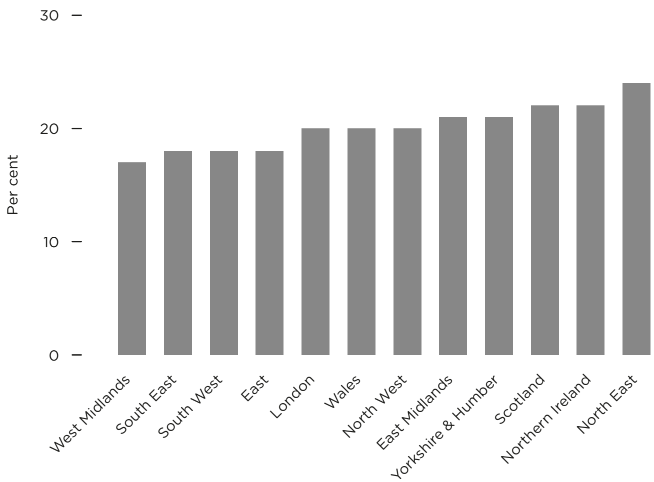
Figure 10 **Proportion of SMEs in Scotland and English regions receiving business loans, 2012–13**



Source: *SME Finance Monitor*

A second factor is likely to be the ability of businesses to provide collateral to secure loans against. This is likely to be linked to the property wealth accumulated by homeowners in different parts of the country. Data from the Office for National Statistics (ONS) show that between 2010 and 2012 the property wealth accumulated by homeowners was skewed heavily towards London and the South. Median household net property wealth is at its highest in London and the South East and lowest in the North East and Scotland. Property prices increased fastest in London and decreased fastest in the North East, so the net property wealth of those with some housing equity grew, without those owners necessarily having paid down mortgages.[43]

Figure 11 **Proportion of SMEs that injected personal funds into business, regions of UK, 2013**

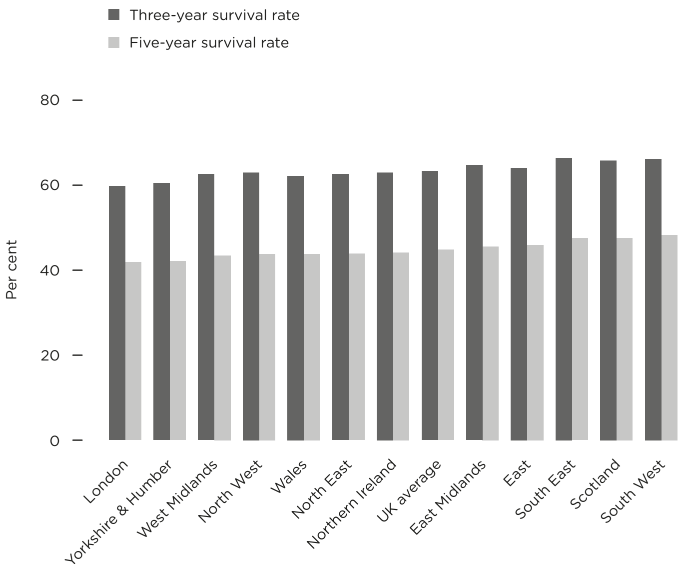


Source: *SME Finance Monitor*

Many factors influence geographical imbalances, from the availability of skilled labour to the quality of infrastructure. Access to finance is simply one piece in the puzzle. However, the lending data suggest that bank lending at least goes with the grain of the imbalances we already have. The point is not that banks are acting irrationally, or with malintent. Banks need to deliver hurdle-rate returns and this becomes even more challenging in areas where businesses have less collateral of their own and are more likely to fail in the next few years.

The problem for these areas as a whole, however, is that capital both follows wealth and generates it. Businesses have a stronger chance of surviving where the economy is strong, and in wealthier areas SMEs are likely to have housing assets to secure loans against. However, as the first chapter noted, investment also helps generate wealth.

Figure 12 **New business three- and five-year survival rate in Northern Ireland and some regions of England, 2007–12**



Source: ONS, 'Enterprise births, deaths and survivals', 2012[44]

The danger is that particular areas of the country get stuck in a vicious cycle of poor performance and low investment. The next chapter turns to the range of policy interventions introduced in recent years to encourage more SME lending around the country.

4 Policy interventions

Since 2010, there has been an increasing focus not just on protecting the taxpayer from bank bailouts in the future, but also in ensuring that the financial system serves the needs of the rest of the UK economy. This stems from the basic insight that while finance is a key industry for the UK in its own right, financial institutions also perform a utility function, helping businesses invest in the future. This chapter explores the reforms that have been put in place since the financial system was stabilised, with the support of the taxpayer.

Competition

Beyond making the financial system safer for taxpayers, the central thrust of recent reforms to financial services has been to increase competition in the banking sector. The rationale for this has been that a more competitive sector would provide better value on price, more innovation in products and services, and a more customer-focused approach to serving businesses. These things would then, in turn, benefit 'the real economy' with businesses better served by the financial system.

The Government's efforts have centred on reducing the barriers to entry for new banks entering the market. In particular, the process for receiving a banking licence was considered to be a problem, taking too long and requiring too much initial investment before applications could even be assessed. A significant investment of seed capital to support firms through this process was required without any certainty that the bank would be authorised. This uncertainty caused problems for firms, as investors were unwilling to commit, key staff are harder to attract, and firms themselves are also unwilling to commit to major projects, such as IT development, until they are relatively far along the authorisation process, building unnecessary delay into it.

The Coalition Government sought both to reduce the overall time taken for new banks to acquire licences – down to within six months from a year or more previously[45] – while breaking down the authorisation process into the distinct stages to provide a more structured approach to authorising new banks.[46] There have also been changes made to the liquidity requirements for the early years of a bank's life, designed to level the playing field between established institutions and new competitors.

To complement these reforms, the Government also sought to smooth the process for depositors to switch from one bank to another. In September 2013, the Payments Council launched a new account switching service. The Current Account Switch Service is a free-to-use service for consumers, small charities, small businesses and small trusts, and is designed to make switching current accounts from one bank or building society to another simpler, reliable and hassle-free.

Most recently, the Government has consulted on new measures designed to enhance competition in the SME lending market in particular. In the 2013 budget the Government announced that it would explore options for enhancing access to SME credit data, enabling a wider range of lenders to assess applications for loans to smaller businesses.[47] This is to be achieved through requiring banks that hold businesses' current accounts to make available to other lenders information about that business's past financial performance. The idea is that this will give challenger banks and alternative finance providers a stronger basis for deciding whether to extend credit to those businesses.[48]

Impact

Many of these reforms were implemented only recently so it is too early to tell whether they will make a significant difference in the long run. There are some encouraging signs of more competition: when Metro Bank opened its doors to customers in 2010 it became Britain's first new high street bank in over 100 years. In 2014 the FCA revealed that 29 firms had applied for authorisation to become banks, holding out hope that there are more institutions in the pipeline. On the other hand, the recent market study into banking services for small- and medium-sized businesses conducted by the CMA and FCA was blunt in its assessment. The report found the following:

- The sector remains concentrated with 85 per cent of business current accounts and 90 per cent of business loans in England and Wales provided by the largest four providers.

- New entry has been limited and there are still high barriers to entry and expansion for newer and smaller banks.

- SME customers believe there to be little differentiation between providers.

- The banks with lower customer satisfaction levels have high market shares and are not losing significant market share.[49]

The CMA and FCA study did not look at whether greater competition can be enough on its own to close the SME lending gap identified by Breedon and others, or to redress the regional imbalances covered in the last chapter. A serious debate is needed about whether the UK simply needs more banks, or rather whether a different type of institution is required. The analysis in chapter 3 explored the structural difficulties that shareholder-owned banks, which must achieve hurdle rates of return, have in increasing lending to SMEs. More competition ought to be welcomed in almost any marketplace, but it is far from clear that more competition from shareholder-owned banks will overcome this particular problem.

Lack of diversity

One indication that the government accepts that there is a structural problem with lending to SMEs that cannot be solved by competition alone is that it has engaged in a range of other interventions designed to increase the overall volume of SME lending. These have included:

- Project Merlin: an agreement in 2011 between government and the major UK banks to extend lending to businesses, including specific commitments on SME lending

- Funding for Lending, a Bank of England and Treasury scheme, introduced in 2012, designed to reduce banks' own borrowing costs, in order to 'incentivise banks and building societies to boost their lending to the UK real economy'[50]

- the National Loan Guarantee Scheme, launched in 2012, allowing banks to raise cheaper funding under a government guarantee, provided they pass through this lower cost of funding to smaller businesses

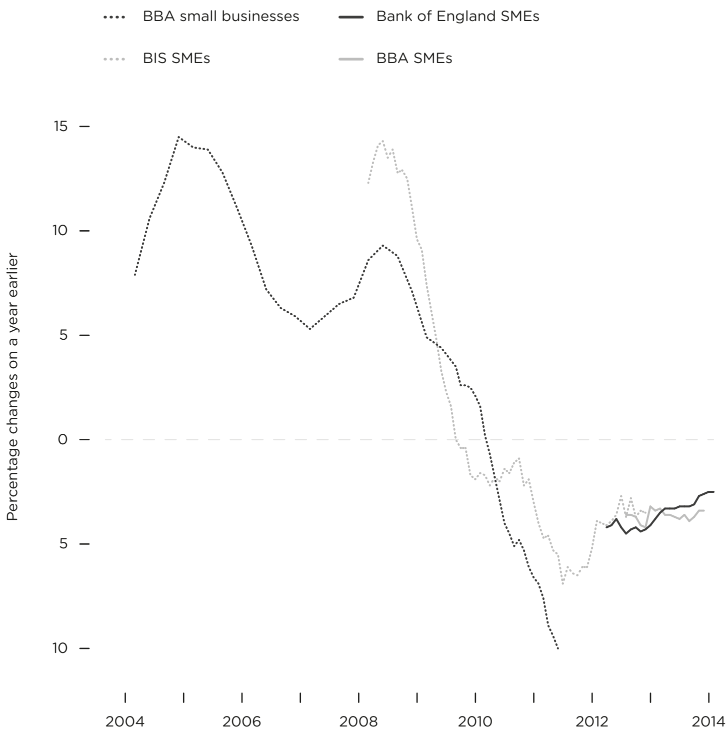
In addition to these individual schemes, the Government has also established the British Business Bank, a public institution that works by channelling funding through existing commercial lenders to start-ups, growth firms and viable but underfunded businesses.[51] The British Business Bank has six schemes, which are summarised in table 3.[52]

Table 3 **Schemes of the British Business Bank in 2015**

Name	Problem addressed	Type of scheme
Enterprise Finance Guarantee	Lenders risk-averse towards SMEs without security	Debt
Start-up loans	New SMEs find it hard to borrow because of lack of track record	Debt
Business Finance Partnership	SMEs overly reliant on traditional high street lenders	Debt
UK Innovation Investment Fund	Poor supply of risk capital for new technology companies	Equity
Enterprise Capital Funds	General lack of equity risk capital for SMEs	Equity
Business Angel CoFund	Business angels have reduced capacity to invest in new ventures	Equity

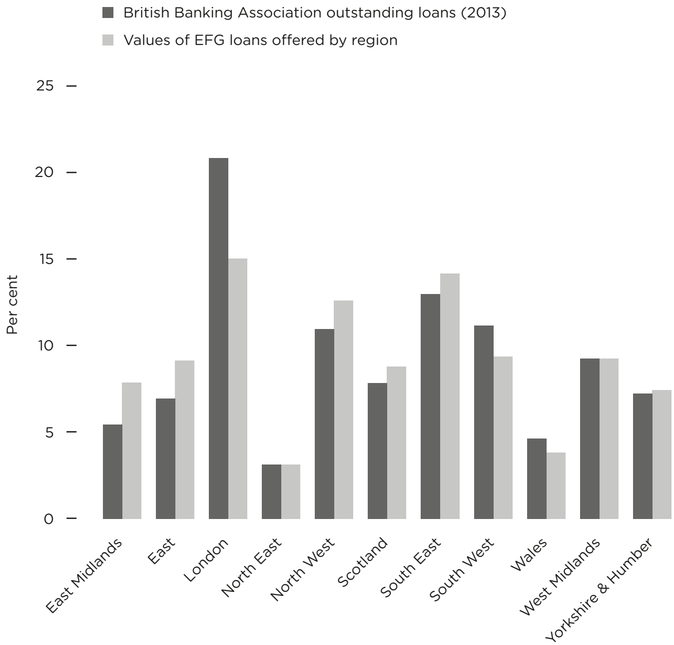
However, despite this long list of interventions, net lending to SMEs has fallen dramatically since 2008 and has flat-lined for the last two years (figure 13).[53]

Figure 13 **Net lending to SMEs, 2004–14**



Sources: British Bankers' Association, BIS and Bank of England calculations

Figure 14 **Total UK lending: proportion of commercial lending compared with Enterprise Finance Guarantee loans, English regions, Scotland and Wales, 2013**

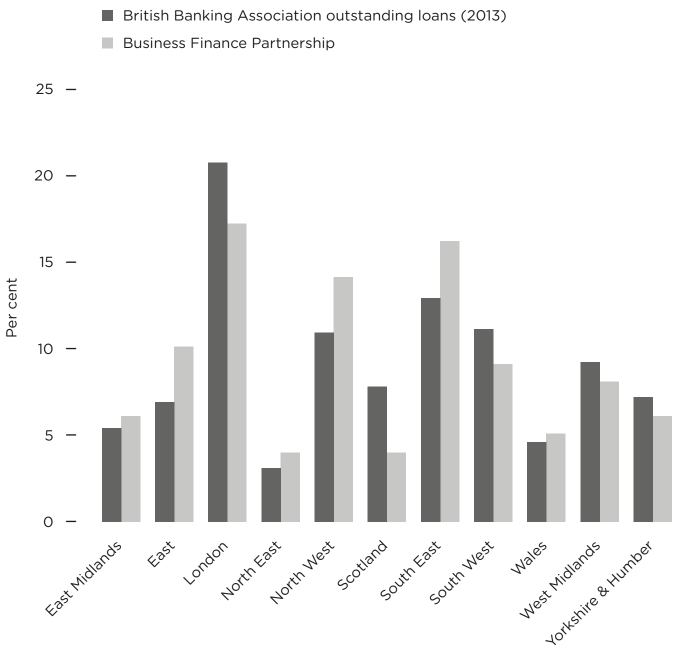


Source: BBA data

Geographical patterns

Not only have the government interventions described above failed to disrupt patterns of lending in the UK economy as a whole, they have also tended to replicate the geographical spread of lending. For example, the Enterprise Finance Guarantee scheme has produced more lending in London than anywhere else and more than three times as much lending in the South East as the North East. Figure 14 compares lending through the scheme in Wales and regions of England with the existing pattern of lending of the commercial banks (BBA data).

Figure 15 **Total UK lending: proportion of commercial lending compared with Business Finance Partnership lending, English regions and Wales, 2013**



Source: BBA data

The Business Finance Partnership (BFP) data show a similar pattern. Areas that already experience relatively high levels of lending also attract more funding through the BFP. However, the BFP has produced more lending in some of the areas with the least pre-existing lending, such as the North East and the East Midlands (figure 15). To an extent this is to be expected – in the short term, at least, lending is likely to take place in areas of the country where there are more businesses, more demand for loans and less'discouragement'. However, in the medium to long term, the question is whether the financial system has a role to play in helping redress imbalances, rather than simply reflecting them. Where public money is used to support lending, this question becomes even more pertinent.

Through the creation of the British Business Bank and the introduction of a number of individual schemes, the Government has adopted a relatively interventionist approach, aimed at affecting the behaviour of commercial banks. However, there is little evidence that this approach has materially affected either overall levels of SME lending, or the broad geographical pattern of SME lending.

One important lesson to draw from this is that it is very difficult to encourage commercial banks to act against their own financial interests. If increasing the volume, or changing the geographical pattern, of SME lending is not in the best interests of banks' shareholders, then it is unlikely to happen.

For this reason, policy-makers have been right to resist calls for a UK version of the US Community Reinvestment Act (CRA). This Act, passed by Congress in 1977, was introduced to encourage banks to increase lending in areas where they were already accepting deposits. The CRA requires that each banks' record lending to low- and moderate-income neighbourhoods be evaluated periodically by regulators.[54] If regulators judge that a bank is not serving these neighbourhoods, they have the power to deny requests for mergers with other organisations, to expand its range of services, or to open up new branches.[55] The regulation was revised in May 1995 and updated again in August 2005, strengthening its original provisions.

It has been argued that the UK needs a version of the CRA, to reverse the patterns of lending described in this chapter. However, this assumes that regulators will be able to corral banks into working against their own interests, without the system being gamed. In complex systems, such as the financial system, targets are often set and apparently met without very much changing at all in reality, beyond the addition of more bureaucracy and costly systems of oversight.

An alternative, more hopeful approach is to help create institutions which are *designed* to increase lending to small businesses – and which have clear incentives to do so. This is the role that local savings banks play in a number of European countries, including those where credit conditions are extremely favourable for SMEs. The next chapter explores this alternative approach.

5 Local banks around the world

In the UK, the Government has sought to increase the flow of finance to small businesses through partnerships between the British Business Bank and commercial lenders. As the last chapter noted, there is little evidence that this has significantly disrupted either the overall volume of lending to SMEs or the geographical pattern of lending. However, an alternative model operates in several other countries, most notably in Europe. In these countries, governments have either created or helped fund separate institutions to perform this job: local banks – institutions with a specific remit to lend to businesses in particular local areas. Often these local banks, which operate in the marketplace alongside commercial lenders, have been supported directly by funding from local or national governments. This chapter considers a number of those models and seeks to draw out the key lessons from the way they operate.

Germany – Sparkassen

The German banking system has three 'pillars': private sector, public sector and cooperative banks. Public sector banks include 422 Sparkassen – local savings banks – which have traditionally been supported by Landesbanken operating at a regional level.[56] Public sector banks account for around a third of banking assets in Germany, with the Sparkassen providing over 40 per cent of all finance to German businesses.[57]

The Sparkassen are legally and financially autonomous institutions, created through acts of legislation. Each Sparkasse has a responsible public body – local or regional government – but no legal owner so the banks cannot be bought or sold. The Sparkassen are endowed with public money and implicitly backed by their responsible public body. They collect deposits and are expected to use the returns they generate from lending to enhance their own capital base.[58]

With these privileges of public funding and implicit support come a specific remit and associated obligations. The Sparkassen must turn a profit but also have a mission to promote the local economy.[59] This includes lending to local businesses, with a particular focus on SMEs, and offering financial services for all German citizens in their respective areas. The Sparkassen operate according to the 'regional principle': each Sparkasse operates branches and extends loans only in their own region so they compete with commercial banks but not with one another.

The duty to promote the economic health of the area they operate in allows Sparkassen to focus on SME lending, which is profitable, but not necessarily profit-maximising. This is the kind of 'vanilla lending' that the FSB calls for[60] in the UK – simple domestic loans, seeking low but steady returns. The result is that the Sparkassen have produced a steady but unspectacular return on capital, normally between 4 per cent and 10 per cent (before tax). This compares with the much greater volatility of the German commercial banks, which have sought higher rates of return on investment and saw their pre-tax return on capital peak at a 20 per cent in 2005 and then drop to -20 per cent in 2008. Depositors of the Sparkassen, meanwhile, have benefitted from the fact that dividends need not be paid out to shareholders.

The governance structure of the Sparkassen is designed to reinforce their remit to operate commercially while fulfilling a wider public mission. The Sparkassen each have a management board responsible for the day-to-day running of the business. The management board must contain sufficient technical expertise: at least two qualified members from within the banking sector. The management board reports to the supervisory board, which ensures that the bank pursues its obligation to promote the local economy, though it has no power or remit to intervene in the day-to-day running. The supervisory board is structured to represent different local interests, including for example local business people, local workers and representatives from the town or city council.

An important part of the model is that each Sparkassen is part of a national network. This helps relatively small, local institutions benefit from economies of scale. For example, membership of the network allows each Sparkasse to have a national presence, ensuring customers can access banking services wherever they are in the country, while the Sparkasse also share some of the technology required to operate as a universal bank. Crucially, the network also adds to local economic resilience, as banks in the network support one another in times of difficulty, ensuring that if local businesses fail in a particular area, this does not lead to the failure of the local lending institution too.[61]

The specific mechanism allowing banks to support one another is the Joint Liability Scheme, a form of pre-paid insurance which requires the Sparkassen to provide financial aid to one another in times of difficulty. The Joint Liability Scheme is designed to protect depositors (above the level of €100,000 provided for by European Union legislation[62]), as well as guarding against moral hazard. Because the Sparkassen must bail one another out in times of difficulty, they have a strong incentive to scrutinise and regulate one another to prevent this from being necessary.

To enable this scrutiny and self-regulation, each Sparkasse has access to information about the performance of other institutions in the network. A traffic light scheme tracks the financial position of each institution,[63] based on monitoring profit and risk indicators, capital ratios and measures of liquidity. The scheme is relied on by a member of the network approximately once a year, but has always provided the safety net required of it. There has been no loss of any deposit, default or insolvency since the establishment of the guarantee system in 1975.[64] Funds are drawn first from institutions in the region where the problem has occurred, giving banks in the network an incentive to keep an eye on their neighbours, and makes use of tacit knowledge about a region.

Following the 2008 financial crisis the Sparkassen have contributed significantly to the economic resilience of the areas that they serve. The German commercial banks dramatically reduced lending since 2008, whereas the Sparkassen increased lending to domestic businesses. The Sparkassen's conservative approach meant that they were less leveraged than the commercial banks, making them less vulnerable. They were also less exposed to swings in global financial markets because of their local 'vanilla lending' model based on taking deposits and making simple, local loans. This left the Sparkassen in a strong position to accept and pass on additional funding, provided by the KfW, the government-owned development bank in Germany seen by many as a potential model for the British Business Bank. This helped produce more resilient local economies, rather than allowing an initial contraction of credit to undermine businesses and create a negative spiral.

Switzerland – cantonal banks

Like Germany, Switzerland also has state-backed savings banks, with a remit to lend in particular areas and promote the local economy. Switzerland is divided into 26 cantons; 24 of these cantons have an associated cantonal bank. Like the Sparkassen, these banks operate as independent institutions. Together, the cantonal banks account for around 30 per cent of banking business in Switzerland.[65]

Article 3a of the 1934 Swiss Federal Law on Banks and Savings Banks defines the constitutional arrangements of cantonal banks:

A Bank which is constituted in the form of an establishment or limited-liability company on the basis of a Cantonal legal ordinance shall be deemed to be a cantonal bank. The Canton must hold a participation of more than one third of capital and possess more than one third of the voting rights. The Canton may guarantee, either in full or in part, for the liabilities of the bank.[66]

This structure allows the cantonal banks to raise additional capital from shareholders, although in practice this is rare.

There is no standardised governance structure for the cantonal banks, but typically the structure involves a board of directors and an executive board. The executive board is concerned with the day-to-day running of the bank, while the board of directors provides oversight, ensuring that the bank serves the cantonal economy.

As with the Sparkassen in Germany, governance structures normally provide for the representation of different interests in the local area. For example, the board of directors at the Cantonal Bank for Geneva 'shall include members with specific powers both in the banking, economic and legal fields. Its composition must, as far as possible, reflect the different tendencies of the Canton's economic and social life'.[67]

Since the Swiss banking crisis of the 1990s there has been a general trend towards cantonal banks de-politicising their boards, though the Financial Stability Board has warned that this process has not been uniform and the IMF has warned that 'the interrelationships between the banks and their cantons may threaten the banks' soundness'.[68]

In addition to their long-standing role of providing relationship banking to a significant proportion of the SME market in Switzerland, the cantonal banks have performed an important role in Switzerland in the aftermath of the financial crisis. While the large commercial banks retrenched, reducing lending by 38 per cent between 2007 and 2011, the cantonal banks lent more rather than less – increasing their lending by 15 per cent.[69] Thus they too played an important role in enhancing the resilience of local economies, by helping maintain the supply of credit while other institutions in the market pulled back.

Spain – cajas

Historically, Spanish savings banks – *cajas de ahorros* – have represented a fundamental pillar of the Spanish banking system. Created from the eighteenth century onwards, the cajas evolved to become state-funded institutions, pursuing a mix of commercial and social objectives in particular local areas.[70] Beyond commercial success, these social objectives included promoting savings, enhancing competition and contributing to regional development.

The governance model adopted by the cajas differs from that adopted by the Sparkassen and cantonal banks, involving a general assembly, a board of directors and a control committee. The general assembly is comparable to the shareholders' meeting of a public limited company, but is attended by members rather than shareholders. These members represent different interests associated with the bank, and include depositors, employees, local business people and local government members. The board of directors (and its chair) is selected by the general assembly and is responsible for safeguarding the bank's social mandate. The control committee provides an audit function, focusing on finances and holding the executive director of the bank (similar to a CEO) to account.

The cajas provide a cautionary tale for local banking, having run into significant trouble during and after the 2008 financial crisis. The IMF identifies three stages in the evolution of the cajas. The first of these phases dates from 1835, when the cajas focused on promoting saving, collecting deposits, making small local loans and reinvesting profits in the institution itself. The second phase dates from 1926, when the cajas' business changed, with more emphasis on providing loans primarily to the public sector. The third phase started in 1977 when the cajas shifted towards universal banking, providing credit to households and SMEs.[71]

The cajas were further deregulated during this third phase, however. From 1988 onwards the cajas were allowed to expand their operations outside their home regions, allowing them to compete on a national and international scale. The cajas were also allowed to adopt a universal banking model, moving them away from 'vanilla lending' and towards investment banking activity. What followed was a period of rapid expansion, funded partly through the cajas engaging in their own borrowing on the wholesale market. The cajas' share of total assets funded by domestic deposits dropped from more than 80 per cent in the early 1980s to 64 per cent in 2010.[72]

This form of expansion left the cajas exposed when the financial crisis struck. Unlike the German Sparkassen, the banks were highly leveraged, having adopted a far more aggressive approach, and were far more exposed to the dramatic movements in global financial markets. The result was a bail-out of the cajas by the Spanish Government, closely followed by several mergers and, ultimately, privatisation into commercial banks.

Beyond the financial model of the cajas, there are further lessons to be learned in the way that they were governed. There is evidence to suggest that political interference contributed to their downfall. Academic studies have found that cajas were more likely to open new branches and extend new loans in provinces that were politically 'close', implying there was political interference.[73] Cajas whose chairman was previously a political appointee were also more likely than average to underperform financially. Rather than contributing to productivity and economic resilience, the cajas became a drag on local areas and the national economy.

Australia – community-based banking

In recent years Australia has been home to an experiment with a different form of local banking, which can operate independently from the state or public funding. Bendigo Bank, a shareholder-owned bank, formed the community bank model in 1997, which allows community banks to open across Australia through a process of franchising. Under the model, a local branch is owned and operated as an independent company, while Bendigo and Adelaide Bank (formed by the merger of Bendigo Bank and Adelaide Bank in November 2007) provides the wider institutional structure and support, including the coverage of its banking licence and a full range of banking products.[74]

The principle behind the model is that locally rooted institutions, invested in and run by local people, will remain close to the businesses they serve, while generating loyalty from their customers to the mutual benefit of owners and customers. As one executive at the Bank puts it, 'It returns us to the philosophy on which banking itself was founded – that the bank feeds into prosperity, not off it.'[75]

The economic model behind the community banks involves community groups and local institutions pooling their resources to invest in local branches. These local institutions can involve local government but do not necessarily do so. When local branches generate surpluses, Bendigo and Adelaide Bank receives 20 per cent of the profits, while the rest is reinvested in the local branch and the businesses it supports. Since the model was introduced in 1997 the number of branches has grown every year, with a total of 307 new branches created. Of this number, 90 branches have opened in areas where there is no other bank branch.[76]

The management consultant Accenture has evaluated the strengths and weaknesses of the Community Bank model. Accenture is positive about the experiment so far, concluding,

> *Community Bank's franchise model has helped unite and engage rural and low-income communities. By involving local people as franchisees and including the broader community as employees and customers, Bendigo has been able to develop a commercial model that has generated local profit, regenerated employment and instilled a can-do attitude in many communities.*

However, there are notes of caution sounded in the Accenture case study. Scepticism about the profitability of the model is highlighted as one concern, with the report identifying the potential divergence between the non-financial merits of the model and the commercial imperative for the 'model [to] generate acceptable returns for the bank in a reasonable period of time'.[77] This reflects a key difference with the other models of the local banking discussed in this chapter, which each have a wider social mission built into their governing documents.[78]

Lessons

The different features of the local banks discussed in this chapter are summarised in table 4.

Table 4 **Features of local banks discussed in this chapter**

	State funded	Regional principle	Share-holders	National network	Dual bottom line	Can borrow directly from wholesale markets
Sparkassen (Germany)	✓	✓		✓	✓	
Cajas (Spain)	✓	✓			✓	✓
Cantonal banks (Switzerland)	✓		✓		✓	
Franchise banks (Australia)			✓			

Several key lessons emerge from these various banking models and their respective strengths and weaknesses. The Sparkassen and cantonal banks illustrate the potential for local banks, backed by the public sector, to become a valued source of relationship banking for SMEs. Both sets of institutions are profit-making but not profit-maximising, allowing them to focus on the SME market in a way that shareholder-owned banks find difficult. The Australian community bank model replicates some of these features – in particular the idea of locally rooted, independent organisations, which are part of a wider network – but has faced the challenge of aligning commercial imperatives with its model.

The Sparkassen and the cantonal banks have contributed to the economic resilience of local areas – and their national economies – following the financial crisis. Where countries like the UK have suffered from a negative spiral of credit constraint, followed by business failure, followed by further credit constraint, local banks have kept their own credit lines open while continuing to operate profitably. This was made possible partly through support from national state funding vehicles, such as the KfW in Germany, but also through the relatively conservative approach to capital retention of the Sparkassen and cantonal banks.

The Sparkassen provide one further important lesson: that relatively small local institutions are most resilient themselves when they can draw on the strength of a wider network. This is particularly the case for banks which cannot raise capital on the markets. The Sparkassen's Joint Liability Scheme provides this for members of the network. First, it creates the incentives for mutual support and scrutiny within the network, helping individual institutions avoid getting into trouble in the first place. Second, it provides liquidity when banks need it, helping them overcome short-term problems. Third, it helps diversify risk, with local banks in areas experiencing economic problems helped out by those in healthier positions.

However, the Spanish cajas, in particular, highlight several risks to local banking models. The first of these is politicisation, with the evidence suggesting that narrow political goals were allowed to override both the commercial *and* the social objectives underpinning the cajas. Other failures in governance have also been highlighted, including the lack of enough banking expertise on the boards of the cajas.

The economic model underpinning the cajas is also significant – and mirrors the German Landesbanken, which also required significant state bailouts following the financial crisis. The aggressive expansion of the cajas was underpinned by an increase in leverage – leaving lower capital buffers to guard against difficult periods – as well as borrowing on the wholesale market. This shift away from the local deposits, local lending model left the cajas vulnerable to movements in financial markets in a way that was simply not the case for the Sparkassen.[79]

6 UK initiatives

While local banking tends to be associated with countries such as Germany and Switzerland, where the model has existed for centuries, there are several new local initiatives in the UK. This chapter examines three examples: a local bank already in operation, a new institution seeking a banking licence and a credit union seeking to become a local bank.

Cambridge & Counties Bank

Cambridge & Counties Bank is a new challenger bank in the UK, specialising in lending to SMEs within the UK. It takes deposits from households and SMEs, and is set up to make loans of between £50,000 and £1 million to SMEs with a turnover of under £25 million. The bank, which focuses primarily on serving Cambridgeshire, Northamptonshire and Leicestershire, received authorisation from the Financial Services Authority in June 2012.

Ultimate responsibility for the bank lies with its board of directors. This board is made up of three executive directors and five non-executive directors. It sets the overall direction for the bank, including establishing its overall goals, strategy and approach to risk management.[80] Three committees sit underneath the board, focused on audit and compliance, remuneration and risk.

Like the Sparkassen, but unlike the cajas, Cambridge & Counties Bank does not borrow money from the wholesale markets. Instead, its capital base comes from a mixture of deposits, retained profits and investment from Trinity Hall, Cambridge University, and Cambridgeshire Local Government Pension Fund. Each institution owns 50 per cent of the bank. This ownership structure distinguishes Cambridge & Counties Bank from the large high street banks, which face different pressures to achieve a return on capital. Launching the bank in 2012 the then chief executive officer described the niche that Cambridge & Counties Bank would fill:

We're here to help fill the lending gap, or should I be more precise, the lack of lending gap that is currently in the UK economy. So as has widely been reported, currently SMEs, many robust SMEs, are being denied the credit that they should be entitled to.[81]

Having received its banking licence in 2012, the bank achieved profitability in July 2013 and has been in monthly profit since then. The bank prides itself on its 'can-do' approach, with the majority of loan approvals made by the bank going through within 48 hours. In early 2015 it reached the milestone of having lent a quarter of a billion pounds in total.

Despite this rapid growth, the bank's strategy is to hold capital in excess of regulatory requirements, as part of its risk management approach. The bank's decision to focus its work across three counties is designed to avoid excessive concentration of risk in one area. As the last chapter discussed, this is something the Sparkassen achieve through their network model.

Hampshire Community Bank

Local First is a community interest company that plans to launch a local bank in Hampshire, provisionally entitled Hampshire Community Bank. The group includes former bankers and an academic specialising in finance. The bank is to be based on the Sparkassen model,[82] adopting an explicit mission not just to produce annual profits but also to create a strong and sustainable local economy.[83]

As a community interest company, the bank would benefit from an asset lock, ensuring it could never be bought or sold – another key feature of the Sparkassen in Germany. The bank plans to offer the full range of banking services to both businesses and individuals in Hampshire with a particular focus on lending to SMEs to enable them to develop and fund energy efficiency and renewable energy projects. For individuals this will include current and debt accounts, cash and pre-paid cards, credit cards and mortgages. Meanwhile, businesses will be offered current accounts, loans, business credit cards, asset finance and trade finance.

The bank aims to prioritise 'productive' lending – lending that creates jobs and sustainable economic growth, delivers a low carbon economy and enhances local economic resilience. Staff have already begun identifying businesses with high growth potential in the area, set against key criteria. This approach could help overcome the problem of 'discouragement', discussed in chapter 2, whereby many businesses never apply for loans even if they would like them.

The bank plans to:

- provide funding to support £250 million of investment in the Hampshire economy within five years
- create some ten additional jobs for each £1 million of locally focused lending – around 1,250 new jobs over the first five years
- lever additional private sector investment into the Hampshire economy
- generate increased local tax revenues from business rates as a result of increased local business activity
- increase rate of business survival and job retention in the event of a future recession

A major challenge has been to find investment for the bank. The aim of Local First is to raise £14 million in total in equity investments. The minimum investment will be £250,000, yielding a 6 per cent annual equivalent return over a ten-year period.[84] The bank will be profit-making but not profit-maximising, so social investors have been identified as the most likely sources of capital. Local authorities look set to play an important role in this, making use of economic development powers under the general power of competence in S1 Localism Act 2011.[85] Portsmouth City Council is proposing to invest up to £5 million; Eastleigh Borough Council and Test Valley Borough Council are also supporting this initiative as is the University of Southampton.[86] Meanwhile, Local First has secured £250,000 initial seed funding from the Regional Growth Fund allowing it to begin the process of seeking and acquiring a bank licence.[87]

The Bank of Salford

In January 2014 Mayor of Salford Ian Stewart announced his intention to create a local bank for the area to serve local households and businesses. He wrote,

Working with colleagues in the trade union movement, local credit unions and partners from other sectors we are now in the process of creating a genuinely local bank to serve the people of Salford – using Salford money to improve Salford people's lives.[88]

The idea behind the bank is to help relieve the short-term financial pressures on households, while helping local businesses invest and grow.

As things stand, nearly half of Salford residents do not earn enough to cover their living costs, resulting in many resorting to doorstep lending at high interest rates.[89] In addition, many households lack basic bank accounts preventing them from accessing cheaper tariffs, through direct debits, for essentials such as gas and electricity, driving up the cost of living further. The mayor hopes to fill this gap through supporting a local lending institution able to provide basic bank accounts to anyone living in Salford. The bank would also offer an alternative to doorstep lending for household.

Under the mayor's plans, a Bank of Salford would also be designed to improve access to finance for SMEs in the area. This dual role of providing universal access to bank accounts alongside finance to local SMEs would mirror the Sparkassen model in Germany. Access to finance is already a focus for policy-makers in the area. In 2010 the North West Fund was established as partnership between the Northwest Regional Development Agency and the European Regional Development Fund and the European Investment Bank.[90]

The £185 million fund provides debt and equity funding of between £25,000 to £2 million for SMEs in the region. A private company, the North West Business Finance Ltd, was established to deliver venture capital funding, mezzanine finance for fast growing businesses struggling to secure funding from banks, and loan-only funding of up to £750,000 to support SMEs in the area finance growth plans.

One possible home for the Bank of Salford is the Salford Credit Union, which has around 4,000 members and a mission to serve everyone who lives or works in Salford. The credit union already makes business loans but these represent a very small proportion of its work. The average loan is to households at between £700 and £800, with just a over a million pounds' worth of loans made each year.[91] The credit union could provide an established local institution for a Bank of Salford to grow out of.

In August 2014 the credit union held a special general meeting to allow it to become a host service for a 'Children's Bank of Salford', which would be funded by Salford City Council and its partners so that every child in Salford can have a savings account. To create a fully-fledged Bank of Salford, however, significant investment will be required to meet the regulatory requirements for establishing and running a bank. The mayor is exploring the potential for the council to run its payments, payroll and reserves through a Bank of Salford as one way of helping provide cashflow for such an institution.

7 Prospects for local banking in the UK

A network of local banks in the UK, with a specific remit to fund SMEs, could help close the funding gap identified in the Breedon report and elsewhere. The banks could operate at a similar scale to the Sparkassen in Germany where, on average, each local bank serves around 200,000 people, though some are much larger.[92] With England's population of 53 million, this would require around 250 local banks across the country. If the banks mirrored local authority borders this would produce around 150 institutions, depending on the approach adopted in London. An alternative would be larger institutions based on either a local enterprise partnership or even county boundaries.

The banks would be deposit-taking institutions, focused on lending to small businesses in their own areas. They would make loans of up to £2 million to local businesses, including the self-employed. The purpose of these banks would be to increase the overall volume of lending, directing the money from deposits to local businesses, rather than making investments in financial markets. The aim would be to identify a greater number of credit-worthy businesses through rigorous analysis of individual business models. A by-product of their existence would be greater competition for household deposits and for some parts of the SME lending market.

The most important feature of local banks in countries such as Germany and Switzerland is that they are profit-making, but not profit-maximising. This enables the model to work; extending loans to more businesses through local discretion requires skilled staff with the time and resources to properly interrogate each individual business model. This helps local banks make sound investments but also can squeeze profit margins to an extent that is not attractive to profit-maximising institutions. Importantly, it also encourages a conservative approach to risk, including holding more capital to guard against difficult periods. Because local banks are not under pressure to maximise returns they can adopt more cautious approaches so in downturns they can be in a position to lend counter-cyclically, helping support local economies and boosting their resilience.

If institutions are not profit-maximising, the obvious question is how they attract investment. The model is unlikely to be attractive to shareholders, who naturally prefer institutions dedicated to producing a higher return on investment. This creates a major hurdle for local banks establishing themselves so that they are in a position to accept deposits and start making loans. The absence of traditional shareholders may be a key feature of local banks in Germany and Switzerland, but it poses a major challenge for establishing similar institutions in the UK.

The alternative, following the German and Swiss models, is that the state takes on the role of investor, which helps promising locally driven initiatives go to scale. This model enables institutions to adopt a 'dual bottom line' – promoting the local economy as well as turning a profit. This is the model that Hampshire Community Bank has been exploring, with local and national government both pledging funding to help the institution establish itself.

However, as chapter 5 highlighted, public investment generates its own risks, which need to be guarded against. The most obvious of these is political interference. As the example of the Spanish cajas illustrates, there is a significant difference between an independent organisation pursuing a mission and a politicised institution which privileges special interests. Public funding therefore places an even greater premium than usual on effective governance.

To guard against political interference, public funding should not result in public ownership. Even where there is state funding, local banks should be independent institutions, which are legally bound to pursue a dual bottom line, but which cannot be interfered with by either politicians or public officials. This legal independence should be bolstered by rules which prevent those who wield political power from playing a role in the governance structures of the organisation.

Another key risk associated with public funding is moral hazard. This is the risk that, without the (theoretical) disciplines of shareholder scrutiny, publicly funded institutions will behave irresponsibly, expecting the taxpayer to bail them out should they face financial difficulty. The experience of local banks abroad teaches several lessons in the best ways of managing this risk.

First, local banks should have an asset lock, ensuring that they can never be bought or sold. This reduces the incentive for the kind of risk-taking which might drive up the value of the organisation but could also put its future at risk. The Sparkassen, for example, have this kind of asset lock and survived the financial crisis on the basis of a conservative business model. By contrast, the Landesbanken had no asset lock, adopted a much more aggressive approach to profitability, and found themselves reliant on state bailouts.

Second, local banks should avoid exposure to wholesale markets, to ensure steadier and more predictable business models. The local banks that were able to weather the storm of the financial crisis were those which were funded through local deposits and made investments in local businesses. This 'vanilla' model limited their ability to generate very high returns, but also left them less exposed to dramatic movements in global financial markets, which overwhelmed the Spanish cajas and the German Landesbanken.

Third, local banks should be part of a wider network, to provide scrutiny and financial support where necessary. Local banks benefit from the ability to operate on a relatively small scale. This allows them to form long-term relationships with local businesses, building trust and allowing them to draw on tacit knowledge of the area and its economy. However, the risk of locally rooted, independent organisations is that they are vulnerable to shocks. Changes in local economic conditions or a run of poor lending decisions could imperil small institutions with investments concentrated in one area.

Being part of a national network, such as the Sparkassen's Joint Liability Scheme, helps address this problem. Different banks in the network have an incentive to scrutinise and support one another, reducing the risk of institutions suffering severe financial problems. The scheme also helps pool and diversify risk: if one local bank finds itself in difficulty, it can be supported by the rest of the network. This system also protects the taxpayer from having to support institutions that do face difficulty.

This implies that if the state is to become an investor in local banks then it should do so with certain non-negotiable conditions. Any organisation benefiting from state investment should:

- have a dual bottom line, written into the organisation's articles of association and reinforced by its governance structure
- adopt a specific remit to lend to SMEs in their local area
- meet high standards of governance – including the representation of different interests, the exclusion of politicians and the inclusion of sufficient industry expertise
- be precluded from either borrowing from or investing in wholesale financial markets
- be required to join a national network of local banks, allowing for a pre-funded joint liability scheme to be established over time, to support individual banks and protect the taxpayer

The obvious institution to perform this role as an investor in local institutions and 'parent' to the network is the British Business Bank. Around £4 billion of public money has already been committed to the bank. Rather than seeking to channel this money through commercial institutions, as is currently the case, the British Business Bank could choose to invest, instead, in a new network of local banks for the UK. The investment would be used to help banks establish themselves as deposit-taking institutions.

It should be acknowledged that this sum alone would not be enough to plug the SME funding gap identified by Breedon and others. However, there is a virtue to starting small with what would be a new venture for the UK government. The goal should be to establish a network of organisations capable of addressing the problem in the long run, rather than attempt to solve the problem in a single parliament at a time when public spending limits are tight.

Should it wish to increase its impact, the British Business Bank could also choose to make match-funded investments, allowing it to leverage more than its own contribution. Hampshire Community Bank, for example, has secured commitments from local authorities in the area, which could be matched by the British Business Bank loan on the same terms. This match-funding approach would also add another layer of scrutiny for local initiatives seeking public investment.

A further source of funding for local banks could come from the banking sector itself. Since 2011 UK banks have paid a total of £28.5 billion in conduct fines, enforced by the FCA.[93] The money collected by the Treasury from these fines has been used for a range of purposes, including funding the NHS. A more appropriate use of money raised because of misconduct in financial markets would be to improve the performance of the financial system itself. In future, fines paid by the banks for misconduct could be used to invest in local banks with a remit to serve businesses in their areas.

This approach – the British Business Bank investing in local initiatives, with certain key conditions – could provide the basis of a strategy to build a new network of local banks. However, a number of key questions still need to be explored to ensure that any taxpayers' money is safeguarded and the maximum benefit is derived for the economy:

- What is the potential for local banks to attract other forms of investment beyond the taxpayer, such as pension fund investment, or mutual capital?

- What is the extent to which local banks should focus solely on debt or loans, rather than forms of equity investment?

- What is the extent to which the UK workforce has the requisite skill sets to undertake this form of lending effectively?

- What is the appropriate relationship between local banks and other local economic institutions, such as local authorities and local enterprise partnerships?

- What are the best ways of avoiding 'deadweight' costs, so that local banks extend lending to a greater number of businesses rather than simply replace existing lending conducted by commercial banks?

These questions are not insignificant – but nor is the challenge of ensuring that SMEs in the UK are able to grow and prosper in the future. Finding answers to them should be a priority for any political party which seeks to rebalance the economy, improve economic resilience and govern for the whole country.

Conclusion

The UK has a long-standing problem with lending to small- and medium-sized businesses. The 2014 Breedon report, commissioned by the government, estimated this gap to be between £26 billion and £59 billion.[94] In addition, SMEs in poorer areas are less likely to be successful with bank loan applications than those in wealthier areas. This situation makes it harder rather than easier to 'rebalance' the UK economy, with a greater emphasis on productive investments all around the country.

This problem exists not because banks have bad intentions, or are unable to make sensible commercial decisions, but because SME lending is often less profitable than other forms of lending. Therefore shareholder-owned institutions, which have a duty to maximise returns on investment, often find it difficult to justify SME loans in large quantities.

To date, policy-makers have sought to address this problem through a dual strategy of promoting competition and creating a British business bank to work with commercial lenders. However, while additional competition is welcome, it does not address the structural challenge that shareholder-owned institutions face in increasing the overall amount of lending to SMEs. Meanwhile, despite the public money invested in the British Business Bank, SME lending has not yet picked up significantly.

An alternative strategy would be for government to invest in different sorts of banks, drawing on lessons from countries such as Germany, where rejection rates for SMEs are lower than in the UK. The Sparkassen provide a model to be emulated, with their dual bottom line, their independence from government and political interference, their local focus, and their steady but unspectacular approach to profitability.

The British Business Bank could play the role of investor in local banks, helping to knit together a national network of local institutions, each with a mission to turn a profit and support their local economies. Such institutions would need to learn the right lessons from local banks in Europe, where some models of local banking have failed while others have generated more productive, resilient economies. In a tight fiscal climate, the government could make a virtue of starting small and learning lessons in what would be a new venture.

There are several outstanding matters that would need to be tackled before any such network was established with public money. In particular:

- Despite successive government reviews, there is surprisingly little evidence on the scale and nature of the SME lending gap. Alongside quantitative modelling, there is need for a greater understanding of how and why SMEs are 'discouraged' from applying for loans. More work is also required on how and why many are rejected for loans when they do apply.

- Detailed financial modelling is needed not just on how individual institutions could operate but how a mutual guarantee scheme could be financed over time. This is an essential feature of the Sparkassen model, but building up an insurance pool from scratch in the UK is a challenging task.

- In addition to public investment, there may be other ways to finance local banks. These include pension fund investment and mutual capital. Work is needed with these sectors to examine how attractive this idea would be to them – and how compatible it might be with the local banking model proposed in this report.

- Work is required on the skill sets that local banks would need to draw on to make the proposed model work. Are such skill sets available in the UK? How easily could local banks gain access to them?

- This report has focused on SME lending – debt – but there is also a strong argument that the UK needs to develop a stronger 'equity' culture, to support high growth businesses. One question is whether local institutions should play a role in this.

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The UK's economy relies too much on debt-driven consumption, and not enough on business investment and exports. There are also stark geographical imbalances, with a particular reliance on London to generate wealth. This report explores the role that local banking might play in addressing these problems.

The report examines the local banking models that operate in a number of other European economies. It argues that the specific remit of local banks to promote local economies – not to maximise returns to shareholders – enables them to increase lending to more credit-worthy businesses. This is because lending to SMEs can be profit-making, but not necessarily profitable enough to be attractive to shareholder-owned banks.

However, the report identifies a number of pitfalls to be avoided. Local banks must be operationally independent of government, free from political interference, focused on the long-term, supported by strong governance arrangements and part of a wider network. When these features have been absent, local banks have damaged economies rather than supported them.

The report recommends that the British Business Bank should act as an investor in local banks in the UK, helping draw together a network of locally rooted institutions to challenge and support one another. These institutions would be operating a 'dual bottom line' – to promote the local economy as well as turn a profit.

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