The prospects for local banking in the UK

There have been calls for the UK banking system to be reformed to improve the supply of affordable credit to small businesses. Cross-party political interest has been shown in a local banking model as a way to achieve this and to contribute to local economic resilience. This study by Demos explored the financing issues faced by small and medium-sized enterprises (SMEs), assessed existing local banking models worldwide, and examined the role local or regional banks could play in the UK.

The study found that current banking provision does not provide SMEs with adequate funding, and they are seriously affected by the UK's geographical/economic imbalance. Local banks have the potential to address these issues by focusing on the requirements of the local market and having a lower threshold for profit. Such banks already operate in a number of other European economies. The specific remit of these local banks to promote local economies – not to maximise returns to shareholders – enables them to increase their lending to creditworthy SMEs. However, they require operational independence from government and strong governance arrangements in order to thrive.

Recommendations

The British Business Bank should act as an investor in local banks. These banks should be based on the successful Sparkassen model in Germany. They would operate a dual bottom line – to promote the local economy, as well as making a profit. With the help of the British Business Bank they would also lend 'counter-cyclically', helping to enhance the resilience of local economies. Importantly, the banks would also be drawn together into a national network of locally rooted institutions. As with the Sparkassen, this would enable banks to scrutinise and support one another, encouraging good governance and responsible lending.

This offers the broad outlines of a new approach to local banking in the UK. However, further research is needed into a range of issues before any such network was established with public money. These include the potential for local banks to attract other forms of investment and the best ways of avoiding 'deadweight' costs – so that local banks extend lending to a greater number of businesses and don't simply replace existing lending conducted by commercial banks.

Policy and practice context

The UK economy is unbalanced – it relies too much on debt-fuelled consumption rather than business investment and exports, and there is a broad north–south divide whereby London and the South-East are more productive, have lower unemployment rates and more SMEs. There have been calls for the banking system to be reformed in an attempt to overcome the economy's imbalances by improving the supply of affordable credit to small businesses. In particular, cross-party political interest has been shown in a local banking model as a way to achieve this and to contribute to local economic resilience.

About the study

This research was carried out by Demos between April 2014 and May 2015. The study reviewed the evidence base on current SME lending in the UK, and analysed the strengths and weaknesses of local banking models from around the world as possible solutions to poor levels of lending to SMEs. Case studies examined three examples of different local banking models emerging in the UK. Ten semi-structured expert interviews and four roundtable discussions with policy makers and stakeholders from the private and voluntary sectors explored the evidence and helped test initial recommendations.

How SMEs access finance in the UK

SMEs seeking external finance, rather than using their own resources or re-investing profits, overwhelmingly approach national banks for loans and overdrafts. However, there is evidence of a gap in SME finance. Many small businesses in the UK are discouraged from applying for loans because they fear they will be rejected. Furthermore, though rejection rates for SME bank loans are lower in the UK than the European Union average, they are much higher than for some of the UK's key competitors.

A range of challenges face UK banks in relation to lending to SMEs. Such lending can be expensive as SMEs often require small loans and assessing their creditworthiness has a high fixed cost for the bank. SMEs often lack collateral to secure against a loan. Overall, such loans often do not generate the level of profit banks need to achieve in order to satisfy their shareholders.

Regional patterns in bank lending

SMEs in the poorest areas of the UK are the most likely to be rejected for bank loans or overdrafts, and the most likely to say they have no option but to inject their own funds. This weakens the economic resilience of these areas by limiting the capital available to firms either to invest in the future or to overcome periods of difficulty.

Regional differences are likely to correlate with the lower survival rates of businesses in these areas, increasing the risk costs for banks. As such, weak local economies can damage the prospects for local businesses, which in turn produces less lending for business investment.

A second factor is likely to be the ability of businesses to provide collateral to secure loans against. This may be linked to the lower levels of property wealth accumulated by homeowners in some parts of the UK – median household net property wealth is at its highest in London and the South-East and lowest in the North-East and Scotland.

The problem facing some poorer areas of the UK is that capital both follows wealth and generates it. Businesses have a better chance of surviving where the economy is strong; and in wealthier areas owners of SMEs are also likely to have housing assets to secure loans against. Investment also helps to generate wealth. But some areas of the UK are stuck in a vicious cycle of poor performance and low investment.

Recent policy interventions

Since 2010 there has been an increasing focus not only on protecting the taxpayer from bank bailouts in the future, but also on ensuring that the financial system serves the needs of the rest of the UK economy. This stems from the basic insight that whilst finance is a key industry for the UK in its own right, financial institutions also perform a utility function, helping businesses to invest in the future.

Recent reforms to the financial system have largely been designed to increase competition in the banking sector, to provide customers with better value and to encourage new lenders to enter the market. However, these changes have limited value to SMEs, as the issue remains that shareholder-owned banks face structural difficulties in lending to SMEs. The government has tacitly recognised this with the creation of the British Business Bank (with 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, not only have these interventions failed to disrupt patterns of lending in the UK economy as a whole, they have also tended to replicate the geographical spread of lending.

Local banking models from around the world

An alternative approach to funding SMEs may be to create institutions that have a specific remit to increase lending to small businesses – and that 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.

Several key lessons emerge from a study of these various banking models and their respective strengths and weaknesses. The German Sparkassen and Swiss 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 that are part of a wider network – but has faced the challenge of aligning commercial imperatives with its model.

Both the Sparkassen and the Cantonal Banks have also 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 extended their own credit lines whilst 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 both the Sparkassen and the Cantonal Banks.

However, the Spanish Caja banks, in particular, highlight several risks to local banking models. Evidence suggests that narrow political goals were allowed to override both the commercial and the social objectives underpinning the Cajas. Other failures in governance include the lack of enough banking expertise on the boards. In addition, a shift away from local deposits and a local lending model left the Cajas vulnerable during the financial crisis of 2008.

Local banking initiatives from within the UK

There are several new local banking initiatives in the UK.

A local bank already in operation: The Cambridge & Counties Bank is a new, challenger bank specialising in lending to UK SMEs. It focuses its work across three counties to avoid excessive concentration of risk in one area. The success of the bank to date indicates there is a role for local banking in other parts of the country.

A new institution seeking a banking licence: Local First is a Community Interest Company that 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. It illustrates the challenges of raising capital from banks that are not profit-maximisng.

A credit union seeking to become a local bank: The Bank of Salford is an initiative 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. This represents a more organic approach to creating a local bank.

Conclusions and recommendations

A national network of local banks could offer a new approach to funding SMEs in the UK, thereby helping to improve local economic resilience. Local banks that understand and support their local area could also begin to address the imbalances caused by the financial divide between London and the South-East, and the rest of the country.

The German Sparkassen banks provide a model to be emulated, with their dual bottom line, independence from government and political involvement, a local focus and a steady but unspectacular approach to profitability. Following the German model, this new network of local UK banks could:

- operate at a similar scale with, on average, each local bank serving around 200,000 people;
- be mission-driven, meaning that they are profit-making but not profit-maximising. As such, they would aim to promote the economic health and resilience of the areas they operated in;
- be part of a network that provides mutual challenge and support, including financial support where necessary.

The British Business Bank could act as an investor, helping to knit together a national network of local institutions, each with a mission both to turn a profit and to support their local economies. However, strong governance arrangements would be required to protect against political interference and ensure a prudent, long-term approach.

There are several outstanding questions that would need to be tackled before any such network was established with public money. These include qualitative work to understand more about SME ‘discouragement’ and loan rejection, financial modelling of 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.

Further information

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