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Inclusive Growth Analysis Unit

Financing Inclusive Growth with a GM Community Bank

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Key points

- Increasing the supply of 'patient capital' for small and medium-sized enterprises (including social enterprises) could help strengthen productivity and promote inclusive growth in the Greater Manchester economy.
- Local/regional banks are one way of doing this. There are successful models in other countries and emerging examples in the UK. The RSA's Inclusive Growth Commission recommended their establishment as part of inclusive growth strategies for cities.
- Bank lending to small and medium enterprises has fallen more in Manchester over the last 3 years than in comparative cities and over a fifth of GM businesses report difficulty accessing finance to support growth.
- A community savings bank at the GM level is one option that could be considered. The Mayor's office could work with existing institutions to conduct a feasibility study and evaluate the likely impact on inclusive growth.

Introduction

Pursuing inclusive growth in Greater Manchester demands the development of a stronger and more productive economy in general and in particular support to small and medium size enterprises (SMEs) to help them to move up the value chain, employing more people and offering better wages and progression opportunities. Social enterprises are particularly likely to offer inclusive employment as well contributing to community benefit which promotes inclusion in other ways.

Yet Greater Manchester's Business Survey tells us that many such organisations are held back by lack of access to the finance they need to grow and develop. The UK has, in any case, a highly centralised banking system which some people argue has contributed to uneven investment and regional economic imbalances. Bank business lending contracted after the financial crisis of 2008. By contrast, in Germany, which has a system of regional and local banks, lending to SMEs actually increased over the financial crisis, helping to support them through and beyond a difficult period. This evidence has led to new calls for regional/local banks to be set up as part of inclusive growth strategies for cities, including by the RSA's Inclusive Growth Commission[1], which reports that these ideas are being explored by other cities.

In this briefing, we review evidence that such an approach might be needed in Greater Manchester. We also describe examples of such banks in other places, explaining how they work and highlighting some of the decisions and issues around their establishment.

[1] https://www.thersa.org/discover/publications-and-articles/reports/final-report-of-the-inclusive-growth-commission

Banking and Regional Economies in the UK

The long term sluggishness of the UK's economy outside London, and its slower recovery from the recession, has been widely reported. Only London and the South East have returned to pre-crisis levels of income per head, as highlighted in a speech by the Chief Economist of the Bank of England, Andrew Haldane[2] who also maps the stark regional differences in productivity, weekly pay, wealth, skills levels, unemployment and mortality rates. The regional imbalances become more extreme when comparing smaller areas than Government Office Regions (i.e. the North West or the North East). The Office for National statistics estimates Gross Value Added (GVA) per head of population at the local area level in 2015 ranged from £292,855 in Camden and the City of London down to £13,411 in the Isle of Anglesey, Wales. In Greater Manchester GVA per head in 2015 was £32,114 for Manchester and £15,778 for Bolton and Wigan.

At the same time, the UK's financial system is concentrated in and controlled from London leading to a geographical skew in the nature of capital markets which creates funding gaps particularly for firms in peripheral locations. The Retail Banking Market Investigation by the Competition and Market Authority[3] reported on the concentration of business current accounts in Great Britain. In 2015 80% of all business current accounts were provided by four banks (these were Lloyds bank, RBS group, Barclays and HSBC). A BIS report states there are significant barriers to entry for new banks entering this market so an oligopoly market exists and low levels of SME customer satisfaction are reported but few SMEs switch banks as few alternatives exist[4]. Big banks aim for high risk adjusted return on equity to maximise their share price which tends to cause disproportionate credit rationing for SMEs during downturns in the economy and over charging for credit and services in upturns[5].

A recent national survey by the Bank of England found that a third of firms said they had underinvested over the last 5 years and the reasons cited included lack of internal funds, high cost of finance and lack of access to finance along with financial markets pressure for the short-term returns[6]. The most recent business lending figures from the Bank of England are presented in a TUC blog by Geoff Tily "Banks are lending to buy houses and not to build businesses"[7]. The charts in Tily's blog shows that lending to business fell dramatically after the financial crisis and only started to grow again in 2016. This blog also charts the share of business lending by industry sector and though most sectors are again growing, lending to the manufacturing sector in 2016 actually fell compared to 2015 (though it did grow in 2014). Historically, in 1950 65% of bank lending was to industry (see Martin, et al, 2015)[8] but by 2010 this had fallen to 15%. Over the same period bank lending to financial companies has increased from 10% to 38%. These data led Martin et al (2015) to argue for greater decentralisation of the financial system in order to support a regional rebalancing of the UK economy.

[2] http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech945.pdf

[3] https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf on page 222, point 7.11.

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/522490/bis-16-105-small-and-medium-sized-enterprise-lending.pdf

[5] See: Butzback, O. and von Mettenheim, K.E. (2015). "Alternative Banking and Theory", *Accounting, Economics and Law,* 5:2, 105-171 and Ertürk, I. (2016). "Financialization, Bank Business Models and the Limits of Post-crisis Bank Regulation", *Journal of Banking Regulation*, 17:1&2, pp. 60-72.

[6] http://www.bankofengland.co.uk/publications/Pages/quarterlybulletin/2017/q1/prerelease.aspx

[7] http://touchstoneblog.org.uk/2017/02/bank-lending-into-economy-still-very-weak-and-still-dominated-by-property/

[8] Martin, R., Pike, A., Tyler, P. and Gardiner, B. (2015). Spatially Rebalancing the UK Economy: The Need for a New Policy Model, Downloaded on 17/1/17 from http://www.regionalstudies.org/news/article/spatially-rebalancing-the-uk-economy-the-need-for-a-new-policy-model

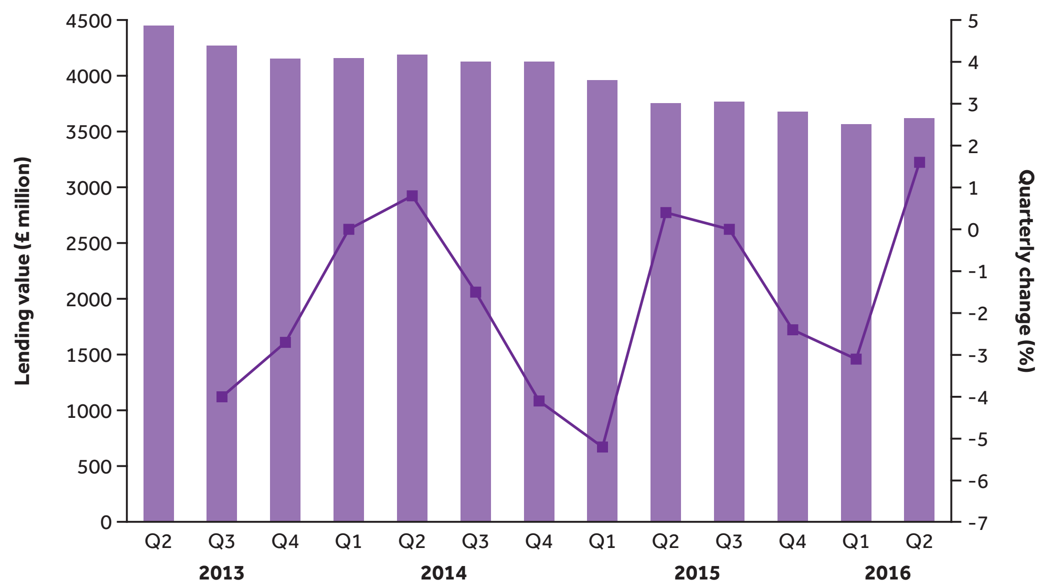

Figure 1: *Greater Manchester SME Bank Lending and Quarterly Change from 2013-2016*

Source: British Banker's Association SME bank lending value by postcode sector

The Situation in Greater Manchester

Business lending data from Greater Manchester suggest some problems with access to finance. The British Banker's Association collect SME lending data for postcode sectors[9] from Barclays, Lloyds Banking Group, HSBC, RBS Group, Santander UK and Clydesdale & Yorkshire Banks. Together these institutions account for about 60% of bank lending to SMEs. In Figure 1 we present the SME lending data by postcode regions across the Greater Manchester area (the postcode sectors are for Bolton, Manchester, Oldham, Stockport and Wigan). From this chart we can see that the value of lending has declined and the change in lending to businesses from the beginning of this sample (2013 quarter 2) is down 18.6% by 2016 quarter 2. For the central Manchester postcode there is a larger fall in lending over 3 years of 24.4%, this compares to the main postcode areas of Liverpool: down 20.8%; Birmingham: down 13.9%; Leeds: down 13.3%; Sheffield: down 2.4% and Newcastle down 3%. It seems like the small increases reported nationally (and for the North West[10]) are not being experienced by businesses in Greater Manchester. This is against a backdrop of large increases in new businesses registered in Greater Manchester in 2016.

One possible explanation for this is that firms are finding alternative sources of funding, possibly from challenger banks, crowdfunding, internal funding (recycling of profits) and Local Enterprise Partnership's growth funds. The LSE Growth Commission graphs net funding raised by UK firms and shows that bond financing has increased as a method of financing since 2008[11]. Evidence on these patterns would be useful for GM.

Meanwhile the GM Business Survey[12] (conducted annually from 2012 to 2015/16) has consistently found that that one of the main barriers to growth for business was access to finance (22% said this

[9] https://www.bba.org.uk/news/statistics/postcode-lending/borrowing-across-the-country-q2-2016

[10] https://www.bba.org.uk/news/statistics/sme-statistics/bank-support-for-smes-3rd-quarter-2016

[11] See Figure 5.4 on page 71 in "UK Growth: A New Chapter", LSE Growth Commission at http://www.lse.ac.uk/researchAndExpertise/units/growthCommission/home.aspx

[12] http://neweconomymanchester.com/media/1779/greater_manchester_business_survey_2016_report.pdf

was the case in 2015/6) and young firms (less than 3 years old) in particular find this to be a problem. In the most recent survey of the firms asked, 17% had sought finance and 36% of these had difficulty accessing finance as they did not meet the criteria or the process took too long. Some reasons given for firms seeking finance was to increase cashflow to support growth (27%) and for capital equipment and vehicles (26%), both essential components for increasing a firm's productivity. The GM survey also found that businesses in the manufacturing and logistics sector were more likely to have sought finance in 2015. Greater Manchester offers advice on access to finance through its Business Growth Hub[13] and more firms that responded to the survey were becoming aware of this service.

The importance of longer term patient finance to help businesses scale up is well recognised in Greater Manchester[14] and for the North as a whole. Notably the British Business Bank has launched a £400 million Northern Powerhouse Investment Fund[15] initiative (administered by Business Finance Solutions[16]) along with the 10 Northern Local Enterprise Partnerships to encourage new firms to start up and established firms to scale up. Business Finance Solutions are regulated by the Financial Conduct Authority and offer firms an alternative to bank finance. They have been backing businesses across the UK since 2002 and have lent £91 million. Business Finance Solutions work alongside other divisions in the Manchester Growth Company that offer business support, mentoring, advice on exporting as well as apprenticeships and training[17].

Research on social enterprise development in the UK and locally suggests that while the obstacles to success for social enterprises are similar to those for SMEs generally, they are more likely than average to find obtaining finance an obstacle, even though the levels that they require are lower than for SMEs overall. Nationally, 39% cited obtaining grant funding as a barrier to their sustainability – the most common barrier experienced.[18] Of course not all businesses and social enterprises seeking finance necessarily have strong business propositions, but equally it cannot be argued that none do. Proposals for regional/local banks are designed to support finance-worthy local businesses to invest and grow.

Regional/local banks exist in other countries

Other countries operate systems of regional/local banks including the US, Canada, Japan and many European countries. The most commonly cited system is the German one, in which local savings banks are known as Sparkassen. Choulet (2016) describes how Sparkassen is part of the broad public sector banking group which includes the Landesbanken (they did suffer losses during the financial crisis)[19]. There are also credit co-operatives in Germany that along with the Sparkassen had very good financial performance since the 1990s. In 2015, the Sparkassen/Landesbanken and credit co-operative banks held 37% of all banks assets in Germany, took 53% of customer deposits, provided 51% of non-financial corporations loans and 54% of domestic households loans.

The regional principle in Germany means that savings banks are restricted to operate within their local area taking local savings deposits and lending to businesses within the locality. The objective of the bank is local economic development and they provide "patient" longer term capital which may be seen as higher risk to commercial banks whose objective is generally profit maximisation.

[13] http://www.businessgrowthhub.com/accessing-finance-for-your-business
[14] http://www.manchester.ac.uk/collaborate/sia/
[15] http://british-business-bank.co.uk/ourpartners/northern-powerhouse-investment-fund/
[16] http://www.businessfinancesolutions.org.uk/about-us/who-we-are/
[17] http://www.businessfinancesolutions.org.uk/funding-available/more-than-finance/
[18] Social Enterprise UK (2015) State of Social Enterprise 2015.
[19] Choulet, C. (2016). "German Sparkassen: a model to follow?", BNP Paribas report April 2016. http://economic-research.bnpparibas.com/Views/DisplayPublication.aspx?type=document&IdPdf=28761

Choulet (2016) criticises the German banking system structure saying it inhibits competition in the sector by limiting banks to serve a geographically defined local area. But the diverse bank framework effectively shielded the savings banks during the 2008 financial crisis and allowed them to increase lending to SMEs (see Simpson 2013)[20]. The German economy experienced only a mild recession in output (GDP) and national employment did not fall during the financial crisis[21]. Excess reserves from the Sparkassen were then used to help bail out the Landesbanken during the crisis.

Hakenes, et al (2015)[22] builds a theory of a financially integrated banking market where rich regions are more attractive to external investments because they have higher initial endowments than poor regions that have fewer projects that need financing. Capital flows from poor to rich regions. In their model an expansion in investment to poor regions with lower levels of economic activity will have a greater effect on productivity than in the rich regions. They empirically test their theory on the German banking sector and find that small bank development improves local economic growth and the effect is stronger in less developed regions.

The German regional banking model has a dual board management structure but this does not translate to the usual unitary board structure of UK companies. Nevertheless, we can learn some useful lessons from the German system which relies on good local knowledge of their customers, responsible lending policies and conservative risk management practices.

Local banking is possible in the UK

The UK does still have some examples of local banking in operation. The Burnley Savings and Loan (or Bank of Dave[23]) began in 2011 and the problems encountered by the owner, Dave Fishwick, for getting a banking licence from the City banking establishment were the subject of a Channel 4 documentary. The Hampshire Community Bank has recently been established by Professor Richard Werner from the University of Southampton, again along the similar lines of the German savings banks[24]. Cambridge and Counties Bank[25] was formed as a partnership between Cambridge and Cambridgeshire Local Government Pension Fund and Trinity Hall, Cambridge University. It offers savings, loans and business support to SMEs within the UK. A Community Savings Bank Association (CSBA)[26] has also been formed and plans to create a UK wide network of 19 mutually owned Regional Community Banks (RCB) to serve the needs of people of ordinary means, local community groups and SMEs.

The benefit of having a RCB is that savings and loans will stay within the locality to create and store wealth for that region and for future generations. This is not a new concept and the ethos of the CSBA is inspired by the Rochdale Principles of Co-operation[27]. This type of bank will challenge the existing model of retail banking within the UK with its short-term culture. Bank staff would be paid moderate salaries without large bonuses and there would be no investment banking activity. The aim is to restore trust in banking and each bank will have constitutional documents with legal protection requiring them to act prudently and responsibly in judging risks and maintaining adequate reserves.

[20] Simpson, C. (2013). "The German Sparkassen (Savings Banks): A Commentary and Case Study", Civitas, from: http://www.civitas.org.uk/publications/the-german-sparkassen-savings-banks/

[21] See page 142 of Sensier, M., Bristow, G. and Healy, A. (2016). "Measuring Regional Economic Resilience across Europe: Operationalizing a complex concept", *Spatial Economic Analysis*, 11:2, 128-151. Available at: http://dx.doi.org/10.1080/17421772.2016.1129435

[22] Hakenes, H., Hasan, I., Molyneux, P. and Xie, R. (2015). "Small Banks and Local Economic Development", *Review of Finance*, 19: pp. 653–683.

[23] https://www.burnleysavingsandloans.co.uk/

[24] https://local-first.org.uk/

[25] http://ccbank.co.uk/

[26] http://www.csba.co.uk/about-us/

[27] http://www.rochdalepioneersmuseum.coop/about-us/the-rochdale-principles/

According to the British Business Bank (2015)[28] UK SMEs have been paying down their debt since the financial crises and in 2014 they were net lenders to UK banks (the value of SME deposits at UK banks was greater than the value of SME overdrafts). SMEs use primarily short-term overdrafts to finance their working capital needs which are expensive. In terms of manufacturing firms, the RCB could offer greater flexibility in loan arrangements as there is often a long lag between buying raw materials and selling the finished product and receiving payments from suppliers. They could support them with exporting and international transactions. The bank should widen inclusion and could offer loans to people who are struggling with the high cost of debt financing. Local savers should also benefit by getting fixed term savings rates and at the same time know they are investing in a bank that will help their local area prosper which should benefit them in the long term

The structure of the RCB is shown in Figure 2. The bank is owned by the customers (members of the public, businesses and community groups). Every citizen who resides within the region is eligible to become a member and will need to purchase one share (£15). The members then pay monthly bank fees (no one can be excluded) and each member has one vote to decide who runs the RCB on the Directors Board and set their pay. Local authorities and other anchor institutions can invest in the bank and they also become members but they are only entitled to one vote so the bank cannot become motived by local political agendas. The banking model for a mutual trust means that it is run by a unitary board which has executive and non-executive directors. Once a member has been with the bank for three years they can put themselves up for election to the board.

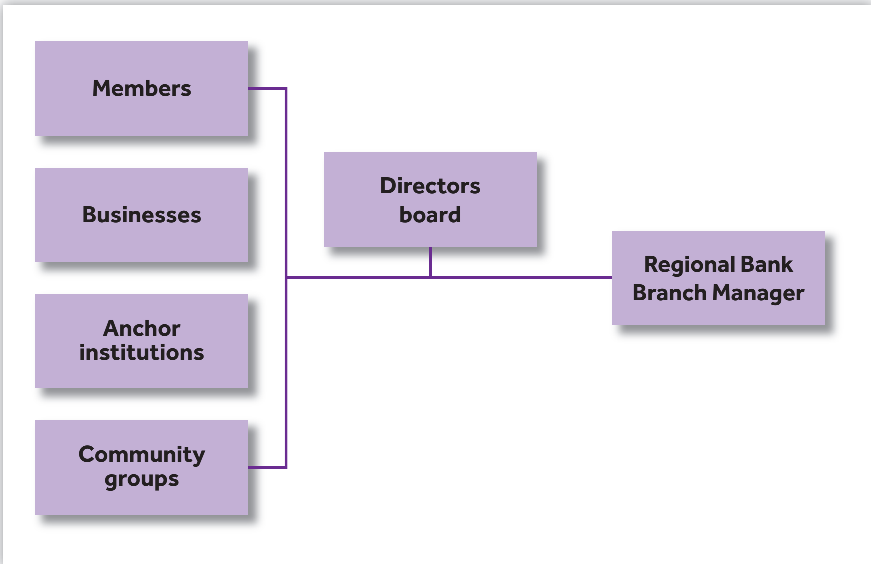

***Figure 2:** Structure of the Regional Community Bank*

The regional bank should have a digital and high street presence. As Which have reported[29] a number of high street banks have been closing branches at a faster rate citing the growth in on-line banking as the reason for closures. Previous bank premises could be occupied by regional bank branches. For Greater Manchester each local authority district could have a high street branch of the RCB with a bank manager available for savings and loan advice for members. The CSBA then suggest a further 18 automated tills for the bank could be located throughout the region (possibly in council offices and town halls) along with on-line banking and a mobile app. The bank would bring well paid jobs to the region and offer good career progression.

[28] British Business Bank (2015). Small Business Finance Markets 2014 report at: http://british-business-bank.co.uk/research/small-business-finance-markets-2014/

[29] http://www.which.co.uk/news/2016/12/revealed-1000-bank-branches-shut-in-two-years-458451/

To be able to be called a bank the RCB must apply to the Bank of England's New Bank Start-up Unit[30] and be vetted by the Financial Conduct Authority and the Prudential Regulation Authority. The CSBA has created a "bank in a box" where it facilitates the application to the Bank of England and each bank is registered under the Co-operatives and Community Benefits Societies Act 2014. The CSBA will award exclusive franchises to each regional bank to operate and use its systems.

Some issues and challenges

Making a local/regional bank a reality presents some obvious issues and challenges. One is the cost of establishing the bank. The initial application to the Bank of England costs £25,000 and the CSBA estimate that £1million is needed to be available for the initial set up process (employment of staff, setting up of IT systems, connecting to real-time banking payment systems, risk testing, branding and corporate governance framework, Bank Chairman and staff legal checks) which can take up to 2 years for the Bank of England then to grant a provisional banking licence. When this is awarded the RCB then has one year to make the final arrangements before it will be fully operational and can be called a bank. The CSBA estimates that £20 million pounds of start-up capital is needed in the first 5 years to underwrite the investment and to get the bank up and running. This capital could be invested by local authorities or a group of anchor institutions. This is a modest long-term investment and the aim is that the bank it should become self-sufficient within 10 years. As we head towards a post-Brexit world European Regional Development funds that go to local authorities could be used to help capitalise regional banks.

Another key issue is getting the scale right so there is a balance between having the local knowledge of business to the size of population in an area. Setting the boundaries for the bank's activities and establishing its relationship to other institutions are also important considerations that could be addressed in a feasibility study. As an example of how much money could be saved if we take the estimate of the number of households in Greater Manchester of 1.17 million from the New Economy key facts page[31], the CSBA estimates that with 65,000 personal and 18,000 corporate members it could have a loan book of around £400 million with deposits of £460 million and would then be making an annual profit of £18 million and have Common Equity Tier 1 capital ratio of 15%[32] of risk weighted assets[33].

The regional bank could become pivotal in the local financial network co-ordinating the knowledge that exists in these institutions. For example, the Bank of England has an established network of Regional Agents[34], Chamber of Commerce offers management training[35] and the Manchester Growth Company already provides loans to business through Business Finance Solutions and offers financial training courses through the Business Growth Hub. The RCB could aim to reduce financial exclusion for low-income communities by working with the credit union sector[36] and help them to overcome problems of attracting middle-income savers.

[30] http://www.bankofengland.co.uk/pra/nbsu/Pages/newbank/index.aspx

[31] http://www.neweconomymanchester.com/media/1567/greater-manchester-key-facts-jan-16.pdf

[32] This compares to Tier 1 ratios at the end of 2015 of 11.4% for Barclays, 11.9% for HSBC, 12.8% for Lloyds, 11.6% for Santander and 15.5% for Royal Bank of Scotland Group as reported in Table 3, page 10 of the Bank of England's Stress Testing for the UK Banking system: 2016 results, November 2016, see: http://www.bankofengland.co.uk/publications/Pages/news/2016/stresstesting.aspx

[33] For a fuller explanation see: http://www.bankofengland.co.uk/publications/Documents/fsr/2015/fsrsupp.pdf

[34] http://www.bankofengland.co.uk/about/Pages/people/agent_biogs.aspx

[35] http://gmchamber.co.uk/services/training-courses--2

[36] Gaining Interest: A New Deal for Sustained Credit Union Expansion in the UK. Goldsmiths, PERC, 2015, at: http://www.perc.org.uk/project_posts/gaining-interest-credit-union-report-launch/

The RCB would offer local business loans at reasonable interest rates, in some cases offering more flexible lending over a longer term than commercial banks. The businesses that could be offered loans would have to demonstrate an ethical business plan that they will create employment opportunities within the region at the living wage.

What could the mayor do?

The evidence presented here is at least suggestive of a need for additional finance in GM to support the growth of local SMEs and social enterprises. The regional bank model is working in many other countries and is beginning to have some traction in the UK. Having a stable local finance sector could be a core pillar for creating more sustainable local economic growth and employment opportunities for local communities where businesses sign up to fair working conditions and pay the living wage.

In this context, Greater Manchester could strive to be a pioneer in rejuvenating the Rochdale Principles by supporting the development of a Community Bank.

The Mayor's office could:

- Further investigate the need for and feasibility of such a bank by engaging with the main finance community in Greater Manchester to see what already exists at the city level, ranging from financial assistance offered to people in credit unions right up to advice for lending to business, and to scope likely investment.
- Develop an impact assessment to evaluate the potential contribution of the bank to inclusive growth.
- Work with the Community Savings Banking Association who can offer support and advice on starting up a GM Bank.

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