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ideas for economic growth

Economic growth remains elusive in Britain. One of the main bottlenecks to growth is the lack of finance to the corporate sector, especially SMEs. The government appears to have little idea of how to resolve this situation. Its initiatives have ranged from small taxpayer-financed investment funds to securing modest pledges from the banks to increase lending through Project Merlin. None of these is sufficient to kick-start economic growth nor resolve the profound structural problems of Britain's banking sector. This month's Idea for Economic Growth is to learn from the highly successful German model of local savings banks (Sparkassen). It features two articles. The first, by Civitas Director David Green, argues that, in contrast to centralised subsidy schemes such as the Regional Growth Fund, localised banking is the genuine free-market path to growth that could revitalise regional economies. It was originally published in *The Daily Telegraph*. In a companion piece, Civitas researcher Kaveh Pourvand outlines just how state-dependent the British banking sector is and contrasts it with the success of the Sparkassen in sustaining the famed 'Mittelstand' sector of SME businesses in Germany.

Local banks for local people

David Green

The Government has struggled to find free-market measures to encourage growth, and has resorted to a taxpayer-funded Business Bank and a Regional Growth Fund. Germany, however, has recovered from the recession more successfully than the UK, to a significant extent because its system of local banks has revolutionised private enterprise. They are the free-market alternative to regional policy, but the Government has shown little interest, even though leaders of Germany's national association of Sparkassen have offered to come to London to explain how to set up similar banks here.

The problem is not just that creditworthy small and medium enterprises (SMEs) can't get loans, it's also that much bank lending is likely to be withdrawn at short notice. In addition, banks often demand collateral, which frequently means that business leaders have to sign over their house. Germany has institutions that overcome these three problems: it is easier to get loans, they are less likely to be withdrawn at short notice, and collateral is replaced by guarantees.

German Sparkassen hold about one-third of bank assets and about 40 per cent of all customer deposits. They provide about 40 per cent of all business loans, and their market share of business start-up loans is 56 per cent. Sparkassen typically operate within the boundaries of a local council and can't lend outside. During the German recession they increased loans to business while the large commercial banks cut them.

The significance of local relationship banks is that they empower people in local areas to solve their own problems. They take local deposits and lend them to local businesses so that individuals with energy, entrepreneurship and determination have the power to make a difference.

Losses are relatively low because customers are known by reputation. How is political corruption avoided? Sparkassen are legally required to act according to sound business principles, but there is also central control. Loans are monitored by the national association, whose officials try to protect the Sparkassen brand. The oversight is not of the 'box-ticking' type favoured by UK regulators, rather it is based on the encouragement of a culture of professional service backed by draconian punishment when conscience fails. Managers who go too far, perhaps by making soft loans to political allies or friends, know that they will never work in banking again.

In the UK, we used to have similar institutions until the TSB was privatised in the 1980s. One bank, the Airdrie Savings Bank, stayed outside the TSB group and still exists today, allowing us to estimate how modern trustee banks might have functioned. It has eight branches and 60,000 customers. Eighty per cent of its loans go to local businesses. Thirty-five per cent are for five years or more. Good local knowledge has kept losses down so that only 1.7 per cent of total lending was written off in 2010. Like the Sparkassen, the Airdrie Savings Bank increased lending during the recent crisis. Loans were up from £28m in 2006 to £36m in 2010. Similar institutions could have been dotted all over the UK, empowering people to seize the day and take on international rivals. Instead, former TSB branches languish in a bank that can't find anyone to buy them.

What would be the potential impact of local banking? Consider how it might affect an area like Tyneside. The average amount held in savings deposits by UK households is £42,000. Let's assume that on Tyneside, where there are about 400,000 households, the average deposit is £30,000. If 40 per cent of local households used savings banks, that would mean deposits of well over £4 billion available to back local entrepreneurs. To put it in perspective, the Business Bank is being started with capital of only £1 billion and the current round of the Regional Growth Fund has £2.6 billion to spend.

£4 billion could transform job prospects in the area. And it would not involve Whitehall allocating taxpayer's money to the regions. The people of Tyneside would have the institutions at their disposal to change their own life chances with their own money. Of course, customers would still be free to give their deposits to international banks but German experience shows that, when given the choice, many opt to invest in local enterprise.

Introducing local banks would not be embarking on a slippery slope to collectivism. All productive enterprise depends on legal institutions, such as the shareholder corporation, that serve as vehicles for private initiative. A little bit of local institution-building would make self-help solutions to our economic malaise a realistic possibility.

Small is beautiful: lessons from German banking

Kaveh Pourvand

One of the hallmarks of this government is a wariness to intervene directly in the economy, no doubt because of a wish not to hinder the spontaneous workings of free markets. This is probably why their reforms of the British banking sector have been so timid. There has been no drive to use the state-owned banks to engage in creative institution building. The Vickers reforms essentially keep the current, failed banking structure in place but try to mitigate the inevitable crises by separating the retail and investment banking divisions.

The government ignores the fact that markets are not naturally 'free'. They are embedded in wider institutional frameworks that depend, among other things, on the state. More than most, the banking sector is deeply reliant on state support. A Bank of England paper estimated that the major banks received £100bn in implicit subsidy in 2009 through being seen as 'too big to fail', a status granting them cheaper borrowing costs.[1] Moreover, that analysis did not consider the Bank of England's £375bn quantitative easing programme, the biggest beneficiary of which is the banking sector.

Despite all this, the sector fails to support the real economy. John Kay estimates that while assets and liabilities of British banks exceed £6 trillion, lending to businesses accounts for only £200bn, or three per cent of the total.[2] Of the £1.1 trillion increase in bank lending between 2000 and 2010, 98% went to property and financial services firms while only 2% went to businesses and services in the productive economy. The sector is the prime cause of Britain's low investment to GDP ratio compared with our competitors. The government's reticence about 'interventionism' merely props up an inefficient sector thriving on state largesse. Whatever current policies amount to, it is not a promotion of open and competitive banking.

Creating a regional banking system like the German Sparkassen would help to pluralise Britain's banking system, reduce its reliance on state welfare and make it serve the real economy. There are 430 such regional banks in Germany, with a combined balance sheet of over a trillion euros. Each bank is an autonomous organisation but there is a wider group – the Sparkassen Finance Group – which provides individual banks with services such as mutual insurance which they could not otherwise obtain individually. What is most striking about the Sparkassen is their legal structure. They are best described as intermediary civic organisations, distinct from both market and state. The public bodies responsible for each bank are local municipalities. However, they do not own them. They cannot sell equity stakes in these banks or spend their funds in the local budget. The supervisory board of each bank is composed of local stakeholders, made up of local community, employee and municipality representatives.

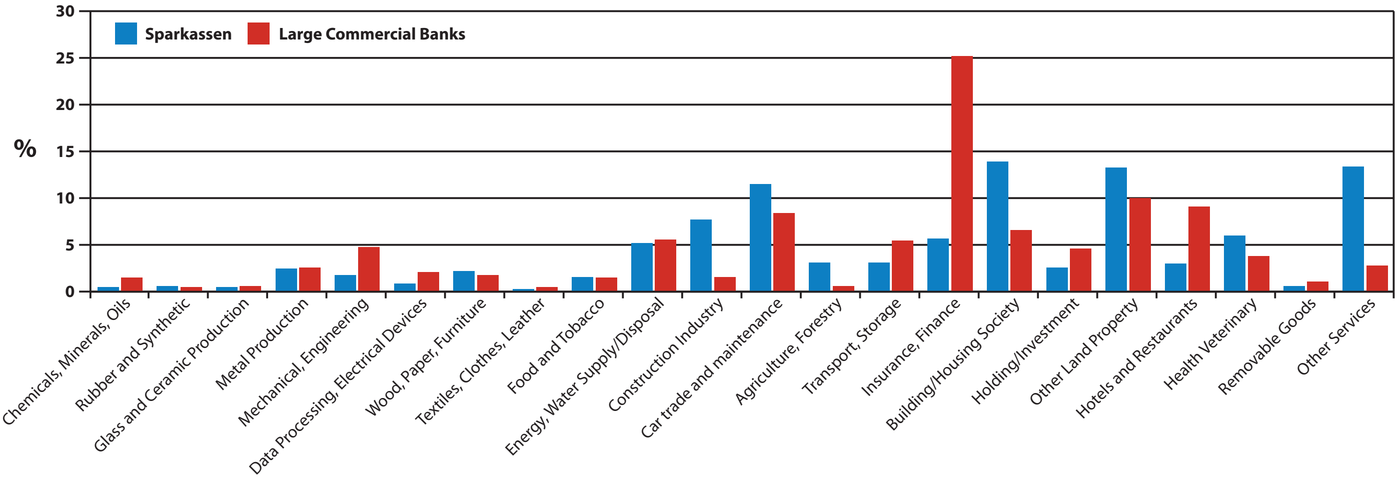
Each bank must lend on sound commercial principles, yet their primary objective is not profit maximisation but economic development of their local area, outside of which they are not allowed to lend. This means that Sparkassen managers develop area-specific knowledge of the local economy, making them well positioned to make lending decisions.

No account of Germany's famous 'Mittelstand' sector of strong SME businesses is complete without reference to the Sparkassen. Nearly 99 per cent of German businesses have annual revenues of less than €10 million while around 75 per cent of German SMEs have a relationship with the Sparkassen. For such businesses, the provision of finance via capital markets is neither economic nor realisable and so the Sparkassen provide crucial support.

Chart 1 documents the industries that the Sparkassen and the large German commercial banks lend to. Much like their UK counterparts, the large commercial banks tend to lend either to large capital intensive sectors, such as engineering, or to property and financial services. The Sparkassen support a wider, more even spread of sectors from agriculture and fisheries to hotels and restaurants.

Their strong local knowledge and commitment to economic development over profit maximisation allow the Sparkassen properly to assess business risk and provide patient, long-term capital to German SMEs. In stark contrast, overly centralised British banks have little local knowledge and prioritise financial returns above wider economic considerations. They are more oriented towards low-risk, high-return property and financial investments to the detriment of the wider economy. The free market economist Friedrich Hayek famously wrote that a free social order is superior to a command economy because it can better co-

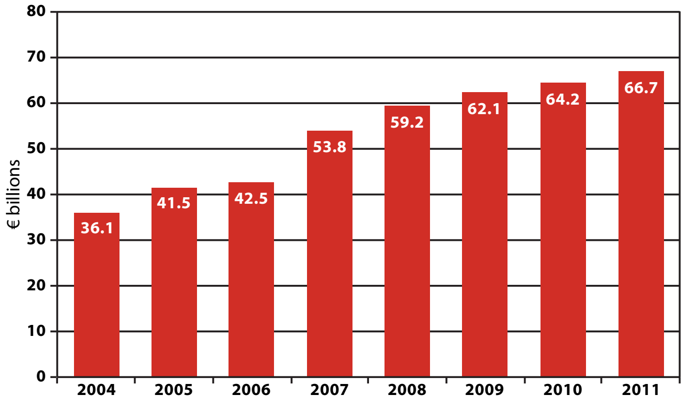
Chart 1: Lending to different industries by the Sparkassen and large commercial banks (as a percentage of total lending)



Source: Deutsche Bundesbank, Bankenstatistik Stand vom 15.8.2011 ordinate specified and tacit local knowledge. In their localism, the German Sparkassen are far closer to Hayekian tenets of healthy social organisation than Britain's oligopolistic and state-dependent banking system.

Their focus on local productive investments over speculation meant that the Sparkassen were not exposed to the vagaries of the financial markets when the 2008 crisis occurred. While the commercial banks in both Britain and Germany reduced lending after the crisis, the Sparkassen progressively increased it, as chart 2 shows:

Chart 2: New loans from the Sparkassen to companies and the self-employed



Source: Christopher Simpson, The German Sparkassen: A commentary and a case study, *Civitas January 2013, p13*

Nor did the Sparkassen require large state bail outs.

How could the UK government create such a banking system? There are two options, which are not mutually exclusive. One is to make use of the great opportunity the government has with state-owned RBS. It already has a branch network, a customer base and well established banking infrastructure in terms of IT, administration and so forth. RBS could be turned into a national system of regional banks while the company's infrastructure could be kept in place to provide individual banks with services they could not provide for themselves. Like the Sparkassen, the banks would only lend in a specific area and would have a duty to promote growth. This would put the government one step ahead of Labour, who support regional banks but do not propose to use the RBS assets for this purpose.

The other option is outlined by Stephen Clarke in a Civitas report.[3] The government could encourage the organic creation of a civic banking network by reducing the very large barriers to entry (it costs £110 million to set up a new bank in the UK, compared with $20 million in the US) and empowering the Charity Commission to help those new entrants deal with the complex regulatory, IT and legal requirements of setting up new banks.

These are the options for the banking sector the government should be considering, if it is serious about growth.

Notes

1 Bank of England, *Financial Stability Report*, December 2010, p51.

2 John Kay, Views on Vickers: Responses to the ICB Report, 2011, p42.

3 Stephen Clarke, *Street Cred: Local banks and strong local economics*, Civitas April 2012, p62-68.

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55 Tufton Street, London, SW1P 3QL

Tel: 020 7799 6677 ■ E-mail: books@civitas.org.uk ■ Website: www.civitas.org.uk