The Industrial and Commercial Finance Corporation: Lessons from the past for the future

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Foreword by David G. Green

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Foreword

Recently there have been calls for the establishment of a new 'industry bank' and the Government has declared its intention of founding a Green Investment Bank. This publication examines the lessons we can learn from the two 'industry banks' that were set up in 1945. In 1945 the Industrial and Commercial Finance Corporation (ICFC) was founded to provide finance for small and medium sized firms and in the same year the Finance Corporation for Industry (FCI) was established to focus on large companies. They were merged in 1973 to form Finance for Industry (FFI), which was rebranded Investors in Industry in 1983,and later privatised as 3i in 1994. By the 1980s the character of FFI had altered for the worse but for some 30 years after World War Two the ICFC and its successor provided an invaluable service that has been missing ever since.

By the 1930s it was recognised that, whilst the City provided invaluable services for commerce, it was very difficult for small and medium-sized enterprises (SMEs) to raise funds for manufacturing. In 1930 the Bankers Industrial Development Company had been established by the Bank of England to fund Britain's basic industries such as iron and steel, but the Macmillan Committee of 1931 recognised that separate provision was needed for SMEs. The committee, whose members included Keynes and Ernest Bevin, discovered that it was very difficult to raise finance in the range from £5,000 to £200,000. The problem became known as the Macmillan gap and the same problem was being called the 'equity gap' in 2010, although the range was from £250,000 to one million pounds.

David Merlin-Jones' study suggests that there are five main lessons from the experience of the ICFC. First, it established local branches and recruited staff who acquired expertise in specific industrial sectors and made themselves knowledgeable about individual companies. This allowed them to make shrewd investments, unlike the leading banks of today. As the British Chambers of Commerce (BCC) has found, the big financial institutions often make sweeping judgements about whole sectors and ignore the merits of individual companies, presumably because they are not prepared to take the trouble of understanding the characteristics of particular firms. In its report on export finance the BCC showed how two companies, one in the materials handling and the other in the automotive parts sector, had been denied export credit insurance because the two sectors were regarded as high risk. The long and successful track record of the two companies affected carried no weight.[1]

Second, the ICFC invested for the long term. It understood that market conditions fluctuate and competitive pressures ebb and flow, sometimes leading to corporate collapse. ICFC backed companies with sound business fundamentals regardless of short-run fluctuations. It proved to be a successful business model that paid off for the ICFC as well as its clients.

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[1] British Chambers of Commerce, *Exporting Britain: Trade Finance*, 2010, pp. 24 and 26.

Third, it would be unwise to establish a new industry bank as a limited company owned by ordinary shareholders who are free to come and go for reasons of their own. What is needed is a bank prepared to back deserving companies over the long term. If funds are to be raised from private investors they should be in the form of bonds or other instruments that insulate the bank from short-term pressures.

Fourth, the ICFC was originally established by the Bank of England and relied heavily on the existing banks. The 'big five' used this dependency to undermine the competitive threat that it posed, and it was only when the ICFC was free to compete head on with the main banks that it was able to meet the demand from SMEs. An industry bank today should be established as a rival for the main banks, not as a dependent offshoot.

Fifth, there are implications for the proposed Green Investment Bank. The ICFC was successful because it set up local branches and got to know local businesses so that it could judge which were promising and which were not. It did not artificially limit support to narrow sectors but focused on selecting well-run firms with good management teams. There is a grave danger that the Green Investment Bank will pile money into the currently trendy 'low carbon' sector at the expense of many economically sound businesses whose products are not currently glamorous but nonetheless are widely demanded by customers. The folly of expecting governments to pick winners has become a commonplace, and it is true that political pressure heightens the risk that governments will invest in politically well-connected bad bets. It is also true that to some extent governments can not avoid picking winners, and fine judgements must sometimes be made. But the Green Investment Bank is a classic example of selecting a sector on political rather than commercial grounds. A general industry bank prepared to search high and low for any promising businesses in any sector and any locality would be far more use for our economic survival.

David G. Green

Introduction

The Industrial and Commercial Finance Corporation (ICFC) was created in 1945 as part of a political decision to increase the availability of funding to small and medium sized enterprises (SMEs). Its creation was a reaction to the findings of the Macmillan Committee's report of 1931 which realised: 'there is… no recognised and readily accessible channel, corresponding to the new issue market for larger firms, through which the small industrialist can raise long term funds'.[2] The problem became known as the 'Macmillan gap'. The City and the Stock Exchange were focused on overseas commerce and the 'big five' banks that dominated British banking did not find raising long-term capital for SMEs sufficiently lucrative. The cost to them of providing a loan or making an equity investment of £100,000 was roughly the same as for a much larger sum. The ICFC was created in the hope of plugging the Macmillan gap as its Memorandum of Association made clear. The company aimed: 'to provide credit… for industrial and commercial business or enterprises in Great Britain, particularly in cases where the existing facilities provided by banking institutions and the Stock Exchange are not readily or easily available'[3]. The ICFC therefore was to provide funding from the point commercial banks stopped lending: at £5,000 to £200,000 where normal lending resumed.

The committee, whose members included Keynes and Bevin, thought that the Bankers' Industrial Development Company, founded in 1930, could play an important role, but it also argued that it was not necessary for only one institution to be founded. They thought that a measure of competition would be beneficial.

The ICFC was successful in partially alleviating a huge problem, but the Macmillan gap was so wide, and demand for ICFC loans was so great that a considerable shortfall remained. On the whole though, the ICFC has been judged a success. The official history was written by Richard Coopey, a Fellow at the LSE and Donald Clarke, an ex-director of 3i. The latter pointed out that the ICFC 'provided a national service at no cost to the taxpayer and a substantial return for its shareholders at minimal cost to them'[4]. By 1987 it was renamed Investors in Industry (3i) and became a private limited company focusing on buyouts rather than loans.

The Macmillan Gap remains a problem for Britain to this day, and while successive governments have tried to increase funding to SMEs through direct initiatives and quangos, these measures have rarely been as successful as the ICFC. The creation of a new British industry bank is back on the

[2] Quoted in: Radcliffe Committee on the Working of the Monetary system (para. 937), 1959
[3] G.W. Murphy & D. Prusmann, 'The Industrial and Commercial Finance Corporation – A Progress Report', *The Manchester School,* Vol. 36, 3 (September 1968), p. 226
[4] R. Coopey & D. Clarke, *Fifty Years Investing in Industry* (1995), p. 376

political agenda and the purpose of this online briefing is to explore the lessons that could be learnt from the ICFC. A brief comparison is made with the German development bank, Kreditanstalt für Wiederaufbau Bankengruppe (now known as KfW).

The Coalition has announced that it intends to establish a 'Green Investment Bank' to put public funds into low-carbon enterprises, but this is an example of 'picking winners' at its worst. The Government has decided that it will only back green manufacturing, when what we urgently need is a bank that will appraise the viability of all ventures, green and otherwise. Industrial success depends on leaving room for the unexpected.

Initial assumptions

When the ICFC was initially created to fill the Macmillan Gap, there was still scepticism about the Corporation's basic model of targeting business that other banks would often try to avoid. Moreover, the established shareholder banks that were forced to fund the ICFC saw the model in their own terms and therefore assumed that providing long-term loans for high-risk enterprises at a low interest rate was a doomed way to practise business. This reinforced their instinctive disapproval of the ICFC's existence. This view was also apparent within the Bank of England, which felt the creation of the ICFC was a necessary evil to prevent Labour's original hopes for a national investment bank being realised. On the Corporation's birth, the Deputy Governor of the Bank said, 'I don't believe much in this body and hope and expect that they won't do much'[5]. The Bank of England opposed any plans to link the ICFC to government policy or to approach funding regionally. Such opposition was strengthened by the political drive behind the ICFC that gave rise to fears that Britain was moving towards a continental banking model, a view encouraged by the appointment of Lord Piercy who was heavily involved in the Labour Party as the ICFC's first chairman.

The opposition to the ICFC and the accusations of cronyism that surrounded its leaders were almost inevitable, but this was less of a hindrance to the Corporation than might be assumed. Once the model of the Corporation had been decided, it defended itself vigorously: 'neither the Government nor the Bank of England gave any directions to the Corporation. It has given no assistance to, nor conferred any privilege on the Corporation'[6]. This was very different from the German model of the state-sponsored investment bank embodied in KfW which had been set up post-war as the financial channel for the Marshall Plan. It is owned 80% by the Federal Republic of Germany and 20% by the German States and was created to work for the benefit of the whole German nation, something ensured through the political supervisory board that monitors the bank's performance. In return for acting as a political tool when required, KfW receives explicit government guarantees and consequently has a far higher credit rating, which allows it to raise money cheaply. Because it is not a profit seeking company, it is taxed at an accordingly lower level.

It was clear in 1945, as it still is now, that the Macmillan Gap genuinely did exist and that SMEs were seeking funding. Unlike many other large institutions, the ICFC therefore experienced demand as soon as it was created. It had no start-up period of slow growth.

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[5] C. Lonsdale, *The UK Equity Gap: the failure of government policy since 1945* (1997) p. 40

[6] R.V. Murthy, 'The UK's New Financial Corporations: FCI and ICFC' in A.N. Agarwala (ed.), *Public corporations: an expert study* (1945), p. 59

Methods

Importantly, the ICFC was a commercially viable operation and always aimed to be so. It stated that 'while it endeavours to keep its charges low and to offer reasonable terms, it does not provide capital at rates below the market level'[7]. The ICFC took pains to invest wisely in loans and if anything it can be criticised for being too cautious. For example, it could be argued that the ICFC went too far when it avoided all single product manufacturers claiming that they were inherently unstable. Overall its method of evaluating firms proved very successful: while the price of an ICFC loan was negotiated on the basis of a company's future potential, the value of the investment was determined by the firm's past success. This is an important requirement for a new industrial bank to ensure that, unlike commercial banks, it assesses its investments on an individual basis by ascertaining the merits of each firm so that no worthy client is turned away. Sometimes the ICFC was willing to grant a 'holiday' from repayment to allow client companies to manoeuvre through the 'valley of death' period in their growth, where profit does not follow expansion straight away. Through such methods the ICFC helped to provide for each company's long-term survival and growth.

The loans provided by the ICFC were made at a fixed rate of interest. This was highly risky for the Corporation as it was not protected by the rise and fall of market conditions. In contrast, fixed rates that implied predictable annual repayments were highly beneficial to client companies. The ICFC aimed to both 'earn respectable profits'[8] and to 'act as an accelerator in the process of a firm's own capital formation' by allowing the client to reinvest their profits rather than pay them to the bank.[9] Unsurprisingly, no other banks followed the ICFC's example, especially after the interest fluctuations of the 1970s. The ICFC gradually abandoned its strategy in the 1970s and by the time it became 3i in 1983, little evidence of the approach was left.

Another model was provided by the Finance Corporation for Industry (FCI), set up at the same time as the ICFC to provide for large companies. The FCI invested in a narrow number of industries and targeted these sectors alone and therefore it felt market downturns far more: large profits were followed rapidly by heavy losses while, in comparison, the ICFC gained steady but healthy returns. The FCI's comparatively poor performance was due to its sector targeting and, unlike the ICFC, it failed to judge firms on the basis of their commercial viability. For much of its existence, the FCI had

[7] B. Tew, 'The I.C.F.C. Revisited', *Economica,* Vol. 22, 87 (August 1955), p. 225
[8] Murphy & Prusmann, 'The Industrial and Commercial Finance Corporation', p. 230
[9] Corporate Direction International, *The finance of small and medium sized businesses*, (1961) p. 25

at least half of its investments tied up in the steel industry.[10] The ICFC consciously tried to avoid this 'all eggs in one basket' approach and weathered downturns far more effectively as a result. In 1967, 21.4% of the Corporation's investments were invested in 'engineering and electrical goods' but there was otherwise an even spread across all industries.[11] A modern comparison of the two bank models could be drawn with the Green Investment Bank that has been proposed by the Government. Like the FCI, it would be in danger of approaching investments dogmatically focusing exclusively on green high-tech investments. A general industrial bank would be more profitable and more stable.

[10] Murphy & Prusmann, 'The Industrial and Commercial Finance Corporation', p. 235
[11] The table on p. 236 of Murphy & Prusmann gives a full break down by region and industry sector at 31.3.1967

Relationship with the banks

The ICFC was simultaneously reliant on and damaged by the commercial banks. They were effectively forced to fund it and become shareholders (out of fear of nationalisation by the Labour Government) but initially all banks except Barclays refused to help foster the ICFC's business. For example, commercial banks didn't advertising the existence of the ICFC to clients and only referred 'hopeless cases' as well as undermining eventual ICFC offers by offering loans themselves once they learnt of an offer having being made.[12] By February 1946, there had been 430 applicants for ICFC loans but only 89 came from the commercial banks, of which half were from Barclays.[13] This meant effectively that the potential for the Corporation to be integrated into an 'organic chain' of finance was never realised.[14] This caused many teething problems for the Corporation, but also forced it to seek its own clients and evaluate their viability without external help. In the end, these problems became the key reasons for the long-success of the ICFC, by forcing it to be self-sufficient. Any modern industry bank may or may not face the same hostility from commercial banks but it should still seek to compete with them rather than rely on cooperation. Such healthy independence would be the source of its long term viability. Nonetheless, there was still a need for a working relationship between the ICFC and commercial banks because firms relied on the Corporation to provide low-interest loans for long-term funding while the banks were still relied upon for short-term borrowing.

The limits of this working relationship were tested during the credit squeeze which began in 1951, when the banks still had to fund the ICFC to provide money to clients that they themselves were unable to lend to. This highlighted a problem that meant when the peak of the squeeze occurred in 1955, the Corporation was pressured into withdrawing £1 million of business and a suspension of further lending. The ICFC itself felt it was 'being required to bear more than their fair share of successive squeezes'.[15] When squeezed, the shareholding commercial banks tried to offset their losses by reducing their funds to the ICFC and when all the banks did this, the Corporation suffered unduly and Lord Piercy complained that he was 'fed up with being messed about'.[16]

The Radcliffe Committee, the follow-up to the Macmillan Committee, reported that 'there seems to have been from quite early years some feeling in the banks that the undertaking to provide funds

[12] R. Coopey, 'The First Venture Capitalist: Financing Development in Britain After 1945, The Case of ICFC/3i', *Business and Economic History,* Vol. 23, 1 (Fall 1994), p. 265
[13] D.M. Ross, *The clearing banks and the finance of British Industry, 1930-58* (1990), p. 6
[14] C.D. International, *The finance of small and medium sized businesses*, p. 8
[15] Murphy & Prusmann, 'The Industrial and Commercial Finance Corporation', p. 232
[16] Ross, *The clearing banks and the finance of British Industry, 1930-58* p. 8

was burdensome'.[17] This feeling was certainly mutual and Piercy told the Governor of the Bank of England that 'we are entitled to a proper latitude in the conduct of our business and after ten years we deserve the confidence of our shareholders'.[18] The 1959 decision to raise funds on the private market freed the Corporation from spending restraints, as it could raise as much capital as it wished on the open market and £45 million worth of stock was sold to allow engagement in greater investments. This gave the Corporation more independence through less reliance on banks and the banks themselves were glad to be rid of the commitment they had borne. Uptake of the stocks began slowly but rapidly became oversubscribed. However, the sudden influx of capital was too little too late and the constraint on the ICFC had a lasting effect on its growth, having stunted it for a decade. Moreover, the sudden independence and need to produce returns on stock sold meant short-term investing became a more attractive option, something increasingly apparent by the late 1970s.

A modern industry bank's relationship with commercial banks would have to be well defined and protected, and this would require a more amenable atmosphere than that in which the ICFC was created. While such a bank's lending should reflect the conditions of the market, its funding should not be overly reliant on commercial banks so as to prevent their self-interest jeopardising the success of the industry bank. The long-term presence of an industrial bank would have a desirable effect on the ethos of commercial bank lending to SMEs. Lord Piercy stated in 1960 that, 'the example of the ICFC has proved a stimulus to other institutions, large and small, to enter this field. It is possible that the ICFC has done more for the Gap by example than by its exertions'.[19] The banks had to react to the existence of the industrial bank, whose very creation was a critique of their own ability and they therefore began to involve themselves in the previously neglected SME sector.

[17] Radcliffe Committee on the Working of the Monetary system (para. 945)
[18] Ross, *The clearing banks and the finance of British Industry, 1930-58*, p. 8
[19] C.D. International, *The finance of small and medium sized businesses*, p. 18

Relationship with customers

The success of the ICFC was highly reliant on its knowledge of the firms it was supporting. This was a two part exercise, involving collective expertise in specialised investment from the board of directors downwards, as well as familiarity with local businesses through its regional branches. This was a revolutionary method of doing business, and contemporaries noted 'no other City institution has ever thought it needed to bring such a wide range of expertise to bear on the propositions submitted by its clients'.[20] The ICFC employed its own specialists rather than relying on external advice and in the long term this was highly profitable for the Corporation as its bad debts fell to a level that never endangered profits. This was quite an achievement, given many of its clients were 'firms with no real historical accounts, lacking security, and requiring long-term investment'[21]. Its specialised strength in assessing business proposals gave it a huge competitive edge. It proved capable of predicting success of new companies. Moreover, those with potential were given special attention and sought out as clients. A new industry bank could only survive in the modern economic climate by following the same strategy of amassing a wealth of local expertise.

The regionalisation of the ICFC was the product of a perceived need to recreate the nineteenth century conditions of local investment that had been lost in the centralisation of investment through the London Stock Exchanges.[22] The ICFC would take up the role of the locally informed investor who knew the business climate and their client well. This was done through actively attempting to decentralise the Corporation away from London through opening regional branches, the first of which opened in Birmingham in 1950 and was shortly followed by others in Manchester, Edinburgh, Leeds and Leicester, among others. The goal of decentralisation was 'going out and seeking clients on their own ground' and 'participating in local business communities.'[23] While other banks had branches with managers who knew their customers well, this was rarely combined with the level of technical expertise that the ICFC could offer. This is clearly a key policy for any new industrial bank and more critical since the advent of clustering, where companies in the same sector group together to share assets and resources. A regional policy towards investment would bring with it a diversity of industries centred in different localities. This would also strongly complement the current government aim of creating 'local enterprise partnerships' as funding could be sought at a local level. Moreover, the bank itself would gain from being able to properly assess the potential of

[20] Tew, 'The I.C.F.C. Revisited', p. 218
[21] Coopey, 'The First Venture Capitalist: p. 265
[22] Murphy & Prusmann, 'The Industrial and Commercial Finance Corporation', p. 225
[23] Murphy & Prusmann, 'The Industrial and Commercial Finance Corporation', p. 238

companies on a local level with microeconomic knowledge, ensuring that it would not dismiss cases based on national rather than regional trends.

The ICFC aimed to foster a long-term relationship with its clients by acting responsibly, but also in a manner that satisfied the client. The Corporation was normally therefore a 'sleeping' investor unless something went wrong in the firm, in which case it sought to use its extensive expertise to help correct this. Otherwise, the ICFC would offer good advice when this was sought by the client. The result of the continuity of service it offered was that by 1954, of 460 new applications, 155 were from previous customers and 40 had applied more than twice.[24] This was a very different approach to that of normal banks, for whom SME investment was not their normal target and funds available for SMEs fluctuated over time.

[24] Tew, 'The I.C.F.C. Revisited', p. 232

Drift from purpose

By the 1960s, the ICFC had the potential to move away from its original remit as the vehicle to plug the Macmillan gap. This was a two part process, as the criteria for how many and to whom loans were given changed, and the Corporation began focusing on bigger money earners, such as mergers and acquisitions. The first major change was the acquisition of Technical Development Capital (TDC). TDC had been created in 1962 due to the desire to improve high-tech manufacturing and embodied the idea of Harold Wilson's speech on the 'white heat of the technological revolution'. By 1966, the TDC had failed to have a significant impact and the ICFC took it over. High-tech investment is often very risky and long-term and the ICFC had the financial reserves necessary. It also had the technical expertise and ethos to suit this form of investment. By 1970 the Corporation had used TDC to invest £6 million in over 100 companies.[25] A few good businesses performed well such as Oxford Instruments, but otherwise Coopey argued the TDC was 'only a moderate performer, with no real "shooting stars" in its portfolio'.[26]

The loss of the ICFC's overall identity and purpose began in the 1970s, when it merged with the FCI to form the umbrella group of Finance for Industry (FFI). When this occurred in 1973, the purpose of the FFI was stated as, 'to provide medium- and long-term funds for the growth of British Industry'.[27] This had no explicit relation to the Macmillan gap, and had greater freedom more in line with a general commercial bank remit than the specialised institution it had previously been. The transformation continued, especially after the economic slump of 1974 which led to the first yearly loss for the Corporation, announced the next year as £19.9 million.[28] To counter this, the lending policy was widened to allow the ICFC to maximise its potential but again this only served to dilute the purpose of the Corporation in the long-run. Indeed, by 1981, the next recession forced the FFI to seek profit wherever it could be found, which was mostly in the capital restructuring of the firms most severely hit by the recession. By the 1980s, the Corporation's organisation, methods and goals were a far cry from those it had held 20 years previously. Clearly, this raises problems as to how a modern industrial bank would cope in a similar situation when economic downturns mean less demand for its services. The simplest solution would be to ensure the bank would not be tempted by profit but instead simply weather out the crisis with as small a loss, if any, as possible. The ICFC survived the mid-1950s crisis without too much strain, whereas the commercial banks, with their traditional practises, suffered far more.

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[25] Coopey, 'The First Venture Capitalist: p. 267
[26] Coopey, 'The First Venture Capitalist: p. 267
[27] Coopey & Clarke, *Fifty Years Investing in Industry*, p. 114
[28] Coopey & Clarke, *Fifty Years Investing in Industry*, p. 115

Interestingly, by the time of the 3i rebranding the successor organisation to the TDC was given a hard time by the parent 3i Group for being too radical in its approach to investment. 3i Ventures was to be run along the same lines, performing expertise-based long-term investment in high-risk advanced technology. The company failed to perform well in the short-term and according to Coopey, this meant, 'those elements within the 3i Group which had been alienated by what they saw as the cavalier style of 3i Ventures became more vociferous in their criticism of the division'.[29] By the late 1980s, 3i turned on its Venture wing and had become quite conservative in its investments, in ways similar to the banks it had originally been created to counter. With its maturation, a concern for its own interests began to grow and outweigh the potential national interests it had been set up to serve. A modern industry bank could not be allowed to change in shape and interests so dramatically, and should be tethered to its original purpose of providing funding, even if it is not in the company's short-term interest. This could best be achieved through a state funded industry bank that could use its advantage of raising cheap credit to resist short-term commercial pressures.

The development of the ICFC's greater focus on profit began in 1967 when it set up Industrial Mergers Ltd. This move was highly lucrative, but as Clarke admits in the official history, 'such a trend went completely against the traditional areas in which ICFC was developing its strength, the finance of small- and medium-sized businesses'.[30] He has attempted to absolve the Corporation from any blame however, by arguing this 'reflected the fact that a number of ICFC's customers were caught up in the merger wave'.[31] Regardless of this assertion, establishing Industrial Mergers Ltd this was a large departure from the original role assigned to the ICFC. However, because the Government had no control over the activities of the Corporation, nothing could be done to bring it back in line and the trends continued until loans had become secondary to mergers and acquisitions when the company was rebranded in 1983. Ultimately the ICFC's transformation from industry to quasi-commercial bank, to its being finally fully privatised, was the result of there being no strong limit imposed on how the ICFC could spend its money and how funds were raised. As soon as shareholders began to take a stake in the Corporation, they were given an incentive to exert pressure to raise immediate returns, which jeopardised the original principles of SME funding. This raises serious questions for a modern industry bank as to how it would be funded and held to account. The most neutral manner would be to ensure that its articles of association, which since the 2006 Companies Act are now the sole constitutional document for a company, clearly specify the limits to its legitimate activities. The bank should state its intention of filling the Macmillan gap by whichever means it feels is most appropriate, and to put this goal ahead of profit making –

[29] Coopey, 'The First Venture Capitalist: p. 269
[30] Coopey & Clarke, *Fifty Years Investing in Industry*, p. 87
[31] Coopey & Clarke, *Fifty Years Investing in Industry*, p. 87

distinguishing it clearly from commercial banks. The articles of association would therefore allow funds to be raised in the private market, but would ensure that shareholder pressure to seek profit could not trump the main goal of filling the Macmillan gap. While those interested in making a quick buck may lose interest in funding the ICFC due to this, more conscientious long-term investors would still be interested. This can be seen in the ICFC's experience given it started raising its funds fourteen years after its creation, by which time the long-term loans had begun to truly fructify (hence the oversubscription to its stock). The modern incarnation of an industrial bank would perhaps face initial difficulty with raising private capital, but using initial state funds to spark the first investments in SMEs and perhaps a state guarantee to safeguard the purchase of industry bank shares, the potential for private sector success is great.

Limits to success

As we have seen the ICFC's potential was heavily restricted by the lack of cooperation from the commercial banks, but some of its own policies weakened its effectiveness. The aim of the model was to prevent overlapping with the business territory of the clearing banks which fell outside the Macmillan Gap. The ICFC stated that 'the Company will supplement but not supersede the activities of other lenders and financial institutions'.[32] One such restriction was the upper limit of £200,000 that it could loan, which did not rise with inflation and so increasingly tethered the Corporation. The self-conscious avoidance of competition was explicit in the ICFC's *aide-memoire* which explained that 'the Company will not carry on a Banking business; its function will be the provision of medium and long-term credit'[33]. While this meant the *status quo* of banking was preserved, further benefit could have been derived by allowing greater competition with established banks. The ICFC, as it was in 1954, was deemed by ex-employee and sometime economist Brian Tew to be 'excessively scrupulous' in its approach. The Radcliffe Committee also noted that the ICFC rejected more firms than it invested in and so made less of an inroad into filling the Macmillan Gap than had been hoped. Tew's opinion was shared by some inside the ICFC which stated in 1958 that while it had gained £3.8 million of new business that year, without restrictions it could have achieved an addition £7m-£8m on top of this.[34] Tew appealed for 'overlap at the seams' of the Gap to ensure that firms wanting just over the upper limit were not left without funding.[35]

By the time the company was reorganised in 1959 and restrictions were lifted, the Corporation saw a rise in the number of applicants, from 313 in 1958-9 to 392 the following year. As funding became easier to access, demand for it also rose. A modern industry bank would do well to learn from this lesson, that availability of funds has a direct effect on the demand for them. Few would apply if funds were hard to access or unlikely to be granted, so the openness of the bank must be strongly advertised along with its existence in general. As has been seen, the mere existence of the ICFC spurred the banks into providing funding to SMEs they had previously neglected. If the ICFC had competed head on, it would have incentivised this expansion further.

There was a tension between the ICFC's original remit of helping all forms of small industry and its being a commercially viable operation. The Corporation was criticised for not providing enough loans of less than £20,000 but the ICFC attempted to defend itself by arguing that it provided loans to

[32] C.D. International, *The finance of small and medium sized businesses*, p. 11
[33] C.D. International, *The finance of small and medium sized businesses*, p. 13
[34] C.D. International, *The finance of small and medium sized businesses*, p. 73
[35] Tew, 'The I.C.F.C. Revisited', p. 222

companies 'on terms which do not offer a reward corresponding to the risk even if the venture is successful'.[36] The ICFC saw itself as serving its purpose through the sacrifice of profit even if others did not. The conflicting ideals of the Corporation meant that it eventually drifted away from its original remit as it expanded and diversified investments. In particular, by the 1960s, the needs of the smallest firms were being overlooked. Such a tension could be disastrous for a modern industry bank. While the ICFC did not make a habit of investing in failing companies, the few that did fail were often given fresh investment if a new management took over and this 'recycling of worn-out companies' by the ICFC was one of its 'unsung achievements and an important element in its contribution to the economy'[37]. Provided a new industrial bank utilised technical knowledge to the full, this would be possible again.

The designers of the ICFC did not originally stick to the recommendations of the Macmillan Report, which advocated a fully empowered institution that could raise funds in the private market: 'Such a company might issue preference share capital or debentures.'[38] The ICFC did eventually take this form, but only after the hostility of commercial banks had become too much to bear. A modern industry bank should not seek to be so submissive to the *status quo* or trade outside the market. Rather, it should aim to become an integral component of the British financial system.

The ICFC's conscious attempt to offer investment outside of London also appears to have been less successful than could have been hoped. In 1967, 32.4% of all investment was still tied up in the capital and the remainder was mostly concentrated in the Midlands.[39] This was despite the regional Corporation offices and was perceived temporarily as a result of local clients being unaware of the ICFC's services, the legacy of the commercial banks deliberately not informing their customers of its existence. The advances in communications since the advent of the internet mean these problems would be less grave for a modern industrial bank, which could reach its customer base far more effectively. That said, a pro-active policy towards advertising would still be necessary and, as unclaimed government grants have shown, the potential customer should not have to find out about the availability of funds by themselves.

[36] Tew, 'The I.C.F.C. Revisited', p. 229
[37] Coopey & Clarke, *Fifty Years Investing in Industry*, p. 376
[38] Macmillan Committee on Finance & Industry (para. 404), 1931
[39] Murphy & Prusmann, 'The Industrial and Commercial Finance Corporation', p. 236

Recommendations and Conclusion

By the time the ICFC had become 3i, its undertakings were analysed by one report as: 'like other venture funds, its main activities now involve sponsoring management buyouts and buyins, rather than providing "seed corn" and development capital to small enterprises , and it deals mainly with medium-sized enterprises'.[40] The evolution from a specialised and unique investment bank to a generic one was the product of overemphasising the commercial basis of the ICFC, which was given no government aid and had to accept the constraints of the commercial bank shareholders. Forcing the ICFC to survive purely on its own meant that short-term profit-making was over valued. The only viable way to prevent this, in a private sector industry model is to restrain the bank from acting outside the desired area through its articles of association, which would clearly define the limits of its influence and methods. Had the ICFC been established on this basis, it could have raised private sector capital (as it did from 1959), whilst avoiding being drawn into mergers and acquisitions.

The alternative to the ICFC model is that of a state-backed bank, such as KfW, the German development bank. It was set up at the same time as the ICFC, but has stayed true to its original purpose of funding German SMEs through government involvement. The state backing of KfW has far outweighed concerns about competition, as it has maximised its funding through high credit ratings and therefore invested as much as possible in industry, justifying its strong relationship with the state as a quasi-autonomous tool. It is significant that, while KfW's investments are guaranteed, there has never actually been a need to claim any money from the state. The guarantee serves only to supply a comparative advantage to KfW, which is then passed on to the SMEs.

The proposed Green Investment Bank is simply too narrow to provide British manufacturing with the financial stimuli it constantly requires. The focus on green industries, low-carbon power production and advanced manufacturing ignores the vast majority of UK manufacturers who are not a part of this. Despite the attractions of a green economy, Britain's economy cannot survive off this alone and the bank plans should reflect this. As such, it would be no better than the commercial banks who are ignoring the needs of entire sectors for funding. The Government is thinking along the right lines by acknowledging the Macmillan Gap and that industry does require further forms of funding than it currently has access to, but the real solution is to broaden the proposed Bank's remit and its ambitions. A new Industry Bank is a crucial milestone for the Government to consider if it is to ensure the future of Britain as a manufacturing nation.

[40] Anglo-German Foundation for the Study of Industrial Society, *Small and medium sized enterprise financing in the UK: lessons from Germany* (1994) p. 2

Recommendations

In the UK, a new industrial bank should combine the best elements of the private company and state institution. It could initially be set up using state funds, to begin the process of securing a positive track record that would entice private investment. The funds for such a launch are already in existence in government schemes designed for SMEs. The Enterprise Finance Guarantee fund for example already has £500 million for investment and in August 2010 it gained another £200 million to continue the scheme until March 2011.[41] Like the ICFC, a future industry bank could act as a channel for greater SME investment and, after the initial cost of creation, it would fund its future through profits. With the addition of state backing though, it could also raise funds in the market cheaply, utilising rather than relying on this advantage to expand investment into as many SMEs as possible, in order to have the widest effect. Had the ICFC been offered state support, it could also have had an impact on the whole financial system and instituted a long-term change in the system's outlook. As it was though, the ICFC coped well with the constraints imposed on it and managed to maintain an impressive record – this should not be overlooked in the search for an improved model.

The regionalism of the ICFC should also be retained, as these were the key advantages that the Corporation had over commercial rivals. Currently, many commercial banks are accepting and rejecting loan applicants on the basis of the sector their production falls into. This is an oversimplified approach to investment and fails to appraise the merits of individual companies. A return to applicants being assessed by specialists would give SMEs a level playing field in terms of seeking investment and would benefit the banking sector as a whole. The Government should not be afraid of creating a new industry bank, nor of ensuring that its founding document prevents a loss of purpose.

The Macmillan gap has not been closed since it was first identified eighty years ago and the problem is unlikely to ever be fully solved. Similarly, the short-termism of the British financial sector has failed to mature into one with a more long-term perspective. A new industry bank is required to gradually shift investment to a more beneficial long-term perspective. As the ICFC showed, the indirect effects of its existence were as powerful as its direct investments, providing competition and therefore forcing the commercial banks to reassess their own approach to SME funding. The benefits of a new industrial bank should be seen in similar terms, providing an alternative model for others to follow as well as engaging with the SMEs. Again, for the true potential of an industry bank to be realised, government support would be necessary.

[41] Department of Business, Innovation and Skills website (www.bis.gov.uk), *Enterprise Finance Guarantee*

There is another issue to be considered – whether it is best to create one industry bank or multiple ones. The industry bank model is utility based: the bank would perform a necessary function that other commercial banks do not want. Without competition, a single industry bank would have no real incentive to strive for the best performance. Having multiple industry banks would ensure a competitive process that increased mutual learning. Indeed, this was the original hope of the Macmillan report which stated, 'There is no reason why the field should be limited to any one institution. In fact it is too wide for that to be desirable'.[42] This recommendation was never acted on. Multiple industry banks would have to be able to compete with each other to survive as well as, where possible, compete with commercial banks.

[42] Macmillan Committee on Finance & Industry (para. 403)