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Time for a Full Public Bank in Wales?

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Contents

Summary

- This report brings together evidence – from the UK and internationally – on the effectiveness and viability of a full public development bank in Wales. It examines what is meant by the term 'public development bank', how such banks can be financed, whether there is evidence that they can stimulate small and medium enterprise (SME) lending and/or local economic and social development, and the role that governments have in establishing them.
- Setting up a public development bank, in any form, is not easy. Evidence from around the world shows that it is important to be clear about which market failures a public bank is designed to address, and that developing an effective and sustainable banking model in Wales would be a significant undertaking.
- However, there is a lot of evidence to suggest that there are problems in the Welsh banking sector and wider economy that a public development bank could help to alleviate.
- There appears to be a lending problem, and the nature of the current banking system exacerbates this. Lending decisions made away from local areas are less likely to favour SMEs.
- A public bank or network of community banks, creating money with an explicit regional objective, could help boost SME lending and regional economic development.
- Diversifying the banking sector could make it more resilient to crises, and also help to prevent capital drain from Wales to London.
- If a public bank is to be developed in Wales, good governance is crucial. Banks that have stood the test of time and contributed to a public good, most notably the German Sparkassen, have governance arrangements that are designed to prevent overreach and excessive political interference, and stop them from being bought or sold. In some cases where these arrangements have not been established or maintained, the consequences have been disastrous.
- The Welsh Government could follow and learn from the progress of ongoing public banking projects in the UK. It could also carry out due diligence on each potential public development bank model, consider their transferability to Wales, their commercial viability, and their contribution to the public good.

Introduction

Following the financial crisis, there have been repeated reports of insufficient credit for small and medium-sized businesses (SMEs), and inadequate personal banking services in some communities and for some households in Wales. One proposed solution to these problems is to increase the role of the state in the banking sector. Some have argued for a public development bank in Wales, but there has not been a rigorous review of the evidence about what similar arrangements elsewhere have achieved, and whether these could be replicated in Wales. In particular there has not been an examination of the viability of such banking models, and their potential to lead to greater investment and growth in local economies. The Cabinet Secretary for Finance and Local Government asked the Public Policy Institute for Wales (PPIW) to provide analysis of existing evidence – from the UK and internationally - on public development banking, clarify key terms, assess what is known about different models of public banking, and examine their potential transferability to Wales. We were to address five issues:

- What is meant by a 'public development bank' and how it would be financed;
- Whether a public development bank would stimulate lending to SME in ways that private banks do not;
- Whether it would stimulate local economic development;
- Are there examples of public banking models from around the world that could be transferable to Wales; and
- What evidence would be needed to inform decisions about whether to explore the creation of a public development bank.

What is a Public Development Bank?

One of the difficulties with debates surrounding public development banking is that it is often not entirely clear what supporters or opponents actually mean by the term. The National Assembly for Wales Research Service defines a public development bank as:

A state-owned institution that works in areas of market failure to add to the amount of finance small businesses can obtain from the private sector. It addresses issues that small businesses face in accessing finance, as it can be riskier for private sector funders to provide this and they may not be willing to do so (Thomas, 2016).

This is consistent with a broader review of the literature, which facilitates three different (though not necessarily mutually exclusive) understandings of the form that a public development bank in Wales might take:

1. **Greater state ownership or intervention in the economy –** This does not specifically require a bank. It can take the form of an investment fund designed to stimulate economic activity. The Development Bank for Wales, which is due to start operations later this year, is an example of this. It will provide £171m of funding to SMEs in Wales, particularly to help meet the objectives of the Well-being of Future Generations (Wales) Act 2016. But it will not provide many of the services that are typically associated with a 'bank'. It also cannot create money in the way that a bank can (see understandings 2 and 3 below).
2. **A state-owned national bank that funds credit to businesses and projects** - Such a bank would be based on an initial investment by the Welsh Government, which would be used to generate (or leverage) further capital to provide public and/or private loans. It would probably not take customer deposits, but instead generate funding from international capital markets. In short, it would be a sovereign wealth fund focused on national investment. An example is the German KfW (Kreditanstalt für Wiederaufbau, broadly translated as Reconstruction Credit Institute). The KfW issues credit through regional and local banks like Sparkassen (see the third understanding of a public bank, below). Wales does not have those institutions, and how a national Welsh investment bank could develop the knowledge to select projects in local areas is unclear.
3. **Regional/local community banking** - This could be a single bank dedicated to a locality, such as the Bank of North Dakota, or a network of banks serving communities across the country, such as the Sparkassen in Germany. In either case, the bank would have a board of individuals drawn from the local area, be geographically limited in its operation, and be a stimulus for local development. It would require initial start-up funding, and then leverage capital in a similar fashion to existing banks in order to provide credit to local people or businesses, or local government projects.

   The bank would create money itself through making loans. When a bank makes a loan, it simultaneously creates a deposit in the borrower's bank account. The loan creates the deposit. In essence, such a bank would create money out of nothing. Limits on this money creation come from banks, consumers and the central bank. Banks limit lending and money creation by a want to remain profitable. Consumers limit lending by repaying debt, which in effect destroys the money that had previously been created. Central banks limit lending through the setting of interest rates on central bank reserves. It is this process of money creation that would distinguish a public development bank from current SME lending programmes in Wales.

The bank could also take consumer deposits, and would likely aim to be competitive on a small range of banking services. This is the model that most closely resembles a 'bank', and a recent Demos report argues that it could be adopted in the UK. It suggests that each bank would take deposits from customers and offer loans to small businesses in their local area, with a view to increasing the overall volume of lending (O'Leary, 2015).

SME Lending

One of the main arguments cited in favour of a public development bank is that it will stimulate greater lending to small and medium sized businesses. There are two important issues to consider:

- Is credit currently being allocated in Wales in a way that maximises economic prosperity and social outcomes?
- If not, could a public development bank do any better?

Is there a lending problem in Wales?

Data on SME lending in the UK has been collected by the SME Finance Monitor since 2011. The survey was set up to review how banks issue finance to SMEs and how this could be improved.

The most recent report (Davies, 2017) covers SMEs across the UK and finds that there was decreased demand for credit across the SME sector in 2016. Just 3% of SMEs applied for a new or renewed overdraft (down from 8% in 2012), while 2% applied for a new or renewed loan (down from 4% in 2012). The vast majority (80%) of SMEs did not apply for any form of finance in 2016, an increase from 68% reporting no applications in 2012. Only 5% of SMEs reported that they had been declined credit by a bank. Most of these businesses said that they were less likely to apply for credit in the future. However, overall confidence among SMEs that banks would approve credit applications has been on a continually increasing trend since 2013. These data suggest that the main barriers to finance are confidence issues relating to political instability rather than access to credit, but that access is an issue for a small proportion of SMEs. A Federation of Small Businesses (2012) report suggests that access is a greater issue. They argue that the UK banking sector is too centralised and concentrated, and the barriers to entry are too high for SMEs. They explicitly call for a more regional-focused banking system in which SMEs can have trust and confidence.

This evidence sits alongside efforts to analyse structural issues relating to access to finance in the UK. A National Audit Office (2013) report estimated that by 2017 the potential gap between the amount of finance available to SMEs and the amount they need will be £22 billion. Breedon (2012) suggests that this gap is larger. He estimated it to be between £26 billion and £59 billion and suggests that lending is a particular problem for SMEs because they generally seek small loans, which leads to a smaller profit margin. At the same time they usually have more variables for banks to consider than other forms of lending (such as mortgage lending). O'Leary (2015: 38) highlights the key issue here: it is not that SMEs are not profitable for banks, but that they are not profitable enough. This suggests that there is a role for a public development bank that can both alleviate the SME lending problem and yet still be financially viable.

SME Finance Monitor data also show SME data that can be broken down specifically to Wales (see Table 1). This shows that a small number of SMEs in Wales wanted to apply for finance but something had stopped them, and that over a quarter were likely to inject personal funds into their business (of which half felt they had no choice but to do so). Overdraft and loan applications were more successful in 2016 than in 2012, but still over one third of loan applications in Wales were turned down last year. Lee and Brown (2017) analyse earlier years of SME Finance Monitor data, and reach quite pessimistic conclusions for areas like Wales. They find that there is a higher demand for bank finance for innovative firms in peripheral regions (in which they include areas of North Wales), but that they are also more likely to have applications for finance rejected. This supports research by Martin and Sunley (2015), which suggests that banks are geographically discriminatory in their lending practices, and highlights the concentration of SME lending in London and the south east of England.

Table 1: SME lending characteristics in Wales

Permanent non-borrowers	Nearly half of SMEs in Wales (46%) showed no past or future appetite for finance, similar to the UK (47%).
Not-seeking finance	The same numbers of SMEs in Wales (80%) and the UK said that they were ‘happy non-seekers of finance’.
Would-be seekers of finance	Roughly the same number of SMEs in Wales (4%) as in the UK (3%) wanted to apply for finance in the last 12 months but something stopped them.
Borrowing	SMEs in Wales (16%) were roughly as likely as in the UK to report a borrowing ‘event’ in the last 12 months.
Personal funding	SMEs in Wales (29%) were roughly as likely as the UK overall (28%) to inject personal funds into their business. In each case, approximately half chose to while half felt that they had no choice.
Overdraft applications	Most overdraft applications were successful in Wales (83%, compared with 86% in the UK), although this was as low as 60% (compared with 74% in the UK) in 2012.
Loan applications	Loan applications were less likely to be successful in Wales (64%) than in the rest of the UK (73%). As with overdrafts, this is a large improvement on equivalent figures from 2012, with just a 37% success rate in Wales (compared with 58% in the UK).
Obstacles to business	In Wales, the main obstacles SMEs highlighted to running their business were legislation and regulation (18%), political uncertainty (14%) and the economic climate (13%). However, 60% cited none of the listed factors as obstacles. Just 5% of SMEs listed access to finance as an obstacle, down from 10% in 2012.

Source: Davies (2017: 132-134). See text for analysis of this data once controlling for other factors.

This research chimes with evidence collected by Jones-Evans (2015), who argues that SMEs in Wales face particular disadvantages compared with England and Scotland, and that the funding gap might be as much as £500 million each year. Alongside this, neither set of data covers people who would like to set up an SME but feel unable to in the current economic climate, and these also might be people that a public development bank could help. Overall, it suggests that while there may not be a lending problem across the entire SME sector, there are some important issues that need to be addressed in specific sections.

Could a public bank alleviate the problem?

The next question is the extent to which a public development bank can adequately alleviate any issues of SME lending. Stein (2002) argues that, in theory, there should be a connection between the size of banks and business lending. He hypothesised that larger banks were less likely to lend to small businesses as they did not have adequate 'hard' information (i.e. a borrower's recent income and tax returns) and were unwilling to rely on 'soft' information (i.e. the research conducted of the borrower's business model or the character of people within the borrower's organisation).

Berger et al. (2005) apply Stein's hypothesis, and find that not only are small banks better able to collect soft information than large banks, but they are also more willing to act on it. They find that large banks were less willing to lend to firms without financial records, interacted less personally with borrowers, were less malleable with credit constraints, and had shorter and relationships with customers. Cole et al. (2004) also find that large banks rely on standard criteria such as financial statements, whereas small banks are more willing to rely on the borrower's character. Carter and McNulty (2004) find that large banks perform better in credit card lending, where the market is characterised by impersonal relationships, while smaller banks performed better in the SME lending market. However, de la Torre et al. (2015) take a slightly different view, and argue that various types and size of banks offer a comprehensive range of products to SMEs, and do not seek to exclude them from their processes.

Relying on hard financial information can be detrimental to SME lending. Therefore, there is a need to make sure that the right information is getting through in the current system. The evidence suggests that this is currently not happening. In the past, many small businesses had a close relationship with their local bank, so that soft information from the borrower could be quickly understood by the lender. Over time, decisions about lending to small businesses are less likely to be made at local level (Petersen and Rajan, 2002 and Degryse and Ongena, 2005). They are now increasingly likely to be made at a bank's headquarters than at a branch level (Lee and Brown, 2017). Moreover, new technology means that lending can now be based on more automated processes rather than human interaction, and banks have become more hierarchical in structure. The combined effects of these trends has been to make banks more geographically and operationally distant from small businesses.

Bank closures contribute to this problem and a report by the Federation of Small Businesses highlights this as a particular issue in Wales. Large banks were three times more likely to shut a branch in Wales than in London and the southeast of England, and five of the top ten areas affected by the 600 bank branch closures in Britain in 2015-2016 were in Wales - Powys, Denbighshire, Gwynedd, Conwy and Camarthenshire (Federation of Small Businesses, 2016). The Federation argues that while some banks have made efforts to mitigate closures by operating mobile banking units, these do not provide adequate financial advice and information or security.

If bank closures are harming the Welsh economy and communities by preventing access to credit and vital financial services, it is important to know if a public development bank might be in a position to address this. Research by the Social Market Foundation (Evans, 2016) shows that 70% of banking consumers are happy to carry out most of their simple banking tasks, such as checking their balance or paying bills, online. However, 63% of consumers would prefer a face-to-face conversation with somebody if they were making a bigger financial decision. There are differences in the use of online banking between age groups (Kempson and Jones 2000). Overall, young people are less likely to use branches than older people for simple day to day transactions, but they use banking facilities more often overall and are keen to go to branches for support with bigger financial decisions. Evans (2016) concludes that while new technologies are making banking easier, they are not yet a substitute for face-to-face contact in a branch.

The effect of bank branch closures on economic activity is hard to measure. Kempson and Jones (2000) suggest that small businesses are particularly reliant on bank branches. The Federation of Small Businesses (2016) supports this and argues that bank branch closures affect small businesses in rural communities, as they are more likely to require cash purchases than in urban areas. They also conducted a small case study in North Wales, highlighting that bank branch closures mean a small business owner has a 20-mile round trip to bank cash, resulting either in more time away from the business, or more cash stored on site, which presents security issues. North Wales also has issues of internet and mobile phone coverage, which makes online banking services harder to access.

However, the impact of a public development bank on some of these issues is likely to be small. The evidence suggests that a public development bank might be able to offer profitable products to SMEs that private banks either cannot or will not. But this would be dependent on a bank having sufficient community knowledge as to have access to reliable ‘soft’ information, such as a borrower's character, and detailed research on their business model and market. If a public development bank were to be understood as a regional community bank, then this might be a possible avenue in which to support greater SME lending. However, even the most extensive public banking model, opening community banks across Wales, would not be able to replace the branches that have been closed in Wales in recent years. There is also good reason for closing bank branches. They are expensive to maintain, and while they are a very important resource for some customers, they are used by fewer people than in the past. And there are ways to protect banking services for small businesses and individual customers in Wales without establishing a public bank – for example protecting and expanding the cash machine network, improving access to online banking and developing the services provided by the Post Office (Federation of Small Business, 2016). A public development bank is a potentially useful option, but not a guaranteed solution.

Economic and Social Development

Another key argument for a public development bank is that it might generate local economic development and job creation. This might be done in three ways. First, a public development bank could finance businesses to create new jobs and drive economic growth. Second, a public development bank could use the profits from lending to fund projects in local areas and communities, through the arm of an organisation such as a community interest company or a charity. Third, all the profits from banks could be recirculated within Wales, unlike with large commercial banks where substantial proportion of profit 'leaks' out of the Welsh economy to UK and international shareholders, as well as London-based staff and bank executives.

Most new jobs created in the private sector are in high growth start-up companies (Decker et al., 2014). However, financing new SMEs is very costly and often ineffective. Shane (2009) argues that government financing of SME start-ups generates neither employment nor wider positive economic impact. This is because only a small number of SMEs become large contributors to job creation and economic development, and picking out which ones will do so is a very difficult task. Shane's (2009) suggestion is that government financing should not just promote entrepreneurship as a general good, but instead recognise that entrepreneurs are not all equal. If government financing is to work, it needs to concentrate time and money on identifying start-ups that will lead to job creation and economic development. This is to promote a similar model of research and investment as shown in venture capital funds. However, there is evidence to suggest that similar public funds to this have been ineffective in stimulating the high growth businesses that might generate job creation and local economic development (Munari and Toshi, 2015).

Hakenes et al. (2009 and 2015) find that there is a positive relationship between small public banks and local economic development. Their analysis suggests that bigger interregional banks focus on rich regions, while regional banks are more prominent in poor areas. They also find that regional banks are successful in preventing capital drain from poor regions, and help to stimulate local economic growth. Their analysis focuses solely on German Sparkassen banks and we don't know if their results would apply in other contexts. However, alongside the dearth of SME lending in Wales, Huggins and Prokop (2013) highlight that Wales is under-served by existing capital markets, with a funding gap compared with London and the wider south-eastern belt. Financial policies that support community economic growth could perhaps prevent capital drain from Wales to other parts of the UK.

Wojcik and MacDonald-Korth (2015) also find evidence for a centralisation of the financial industry in the UK, and argue that following the financial crisis London has control and command of the financial sector. They compare this to Germany, and argue that the 'prominence of regional and local banks in the German system, underpinned by a decentralized state… has made the German financial system more heterogeneous, diverse and therefore more resilient to [crises]' (Wojcik and MacDonald-Korth 2015: 1050).

As well as contributing to local economic development, a public bank could also contribute to socially desirable outcomes. For example, a significant proportion of the German KfW's lending goes to projects with environmental objectives. Borrowers also receive financial reward if they reduce emissions. This has helped the German government in its aims to insulate homes and meet its climate change targets. The KfW advised the UK Coalition Government 2010-2015 on its Green Investment Bank, however the two have always been very different. The Green Investment Bank is not a bank but a fund, and it was recently announced that it will be privatised. A full public development bank could make investing in socially desirable outcomes a focal part of its lending strategy, as well as investing profits from its business into socially desirable projects.

However, while there are clear incentives to establish a full public bank in order to invest in socially desirable projects, it is crucial that a bank is independent and limited in its operation. Good governance is crucial, and socially desirable lending must still be made with the commercial interests of the bank in mind. As will be shown in the next section, examples of public banks that abandoned good governance to support government policies had disastrous consequences.

Examples of Public Development Banking

One of the main objectives of this report is to bring together the available evidence on public development banking and assess its applicability to Wales. This section describes and analyses public banking in Germany, North Dakota and Spain, as well as discussing examples from the UK that are either fully formed or still in development.

Germany

Germany has what is commonly known as a 'three-pillar banking system', made up of private commercial banks, public savings banks and small credit co-operative banks. The private commercial banks operate in a similar fashion to standard banks, offering a range of financial programmes from savings accounts through to large scale loans and investments. Savings banks and co-operative banks focus more on deposit taking and small-scale lending. They are geographically constrained by by-laws, which restrict access and lending to borrowers from the same administrative district(s) (Behr and Schmidt, 2015).

German Sparkassen are public savings banks, created by legislation. They account for approximately one third of German banking sector assets, and a similar amount to private banks. The Sparkassen were very important for West Germany's economic development following World War II, and again following German reunification after 1989. Each Sparkasse bank has a local governing body but is not legally owned by anybody, in order to prevent being sold. The Sparkassen have an explicit objective of promoting the local economy. They are a network of local banks, competing with other banks in the same local area but not with other Sparkasse in the country. Each bank is part of the Sparkassen national network, which means they have a national brand and reputation, as well as benefitting from institutional economies of scale, but they are legally limited to banking in their defined area to limit risk and overextension (O'Leary, 2015). Each bank serves an average of 200,000 people (although there is considerable variation across the country) (Greenham and Prieg, 2015). Using those figures, if Wales were to develop a local banking structure similar to the Sparkassen model, then approximately 15 local banks would be required. An alternative would be to envisage 22 local banks along the Welsh local authority boundary structure. However, the Sparkassen were formed in very different financial conditions to today, and a Welsh public development bank would likely need to be spread less thinly than the Sparkassen banks. The Sparkassen group are eager to expand the model across Europe, partly to encourage more lenient regulation from the European Central Bank.

Co-operative banks form a smaller part of German's banking sector (they account for approximately one tenth of banking assets, although they provide the majority of German retail banks). They are owned by their members, and lend to SMEs (Coppola, 2015). They have a deposit protection scheme using a levy-based system, so that individual banks are guaranteed by each other. They are also supported by security from central banks. This meant that they largely coped well during the financial crisis, and continued to support SMEs.

The Sparkassen have faced problems recently. Sparkassen have excess deposits compared to lending opportunities, and so they place those in larger public banks or asset managers (Coppola, 2016). Coppola (2016) argues that the Sparkassen model 'depends on there being a tier of compliant larger banks that will find profitable investment opportunities both inside and outside Germany to generate the returns that Sparkassen want to provide to savers'. While this might work in 'good' economic times, the issue is that some of these larger banks and asset managers overreached in the same fashion as other financial institutions around the world, and many of the German regional public banks had to be bailed out. The result is that Sparkassen is no longer able to give as positive returns to savers as it used to. Germany is now more vulnerable to changes in exports, and this leaves Sparkassen more vulnerable too.

Munchau (2017) reaches similar conclusions about the German banking model. German financial institutions are heavily reliant on interest rates being reasonably high. Sparkassen and German co-operative banks rely on local investments, savings and loans. They are funded by customer deposits who want returns, yet they are forced to offer very low interest rates on lending. When savings exceed loans, and central interest rates are low, savings banks have little option but to take on more risks to give savers promised returns. This has implications for whether a public bank could effectively compete with private banks for customer deposits. While the idea that consumers would rather deposit their money in a local bank serving a public good is a popular one, evidence as to whether this would happen is needed.

A key aspect of Germany's banking culture is the Mittelstand. The term is applied to SMEs in Germany, characterised by long-term investment in their workforce and social responsibility to their locality. Their success has meant that there is a consistent stream of demand for credit, which Sparkassen and other community banks then provide. However, it is questionable whether such a culture can be translated to Wales. Across the UK, the history and culture of investment is different from Germany, with banks and people primarily investing in 'safe' assets such as pensions and property (Coppola, 2015). Additionally, Wales's SMEs are mostly small rather than medium-sized. The Mittelstand is not directly replicable in Wales.

However, there is a chicken and egg scenario here. German community banks are not successful just because of the Mittelstand; the Mittelstand has had success because of access to funding from community banks. German Sparkassen and the KfW have provided loans to SMEs in Germany for decades, and O'Leary (2015: 62) argues that this has helped to 'produce more resilient local economies'.

The key question then is the extent to which the German model can be replicated in Wales in a manner that maintains both commercial viability and profit-making, in order to invest in and promote the local economy. For example, efforts to replicate elements of Sparkassen's community banking model in Australia have had success in enabling community regeneration, but have struggled to generate strong financial return (O'Leary, 2015). The German model's strength is its local and diverse limited banking model, backed by being part of a national network, as well as by a state institution (the KfW) for continued funding. Introducing a similar network and structure in Wales could strengthen Wales' SME lending and local economies, but would be a significant commitment both by the Welsh Government and local partners.

North Dakota

The Bank of North Dakota was created in 1919, as part of a broader programme of state investment. The bank collects all state deposits, such as tax payments and fees. These funds are used to finance loans, both for businesses in sectors such as agriculture, but also areas not as common in private banking, such as student loans. The bank is quite conservative in its lending, such as generally avoiding subprime lending. While they have invested in mortgages, and were not completely removed from the banking crisis, their banking model was not as dependent on housing. The bank also provides some of its dividends back to the state each year, which can then be used to offset losses elsewhere or fund public sector spending. Research on the bank and its support for SME lending and local economic development is quite limited, but the bank appears to make a small but continued annual profit, as well as making a payment each year to the state funds. However, while other states have shown an interest in the bank's model, no other state has replicated it. Of interest to Wales is that the savings for Welsh Government institutions banking with a Welsh bank could be substantial. Charges paid on current banking services are likely to more benefit London's economy than Wales.

Spain

The cajas are Spanish savings banks, with most of them created in the 19th century by local councils and religious orders. Their original objective was to fund social and cultural community projects from profits made from local savings and lending (IMF, 2006). Over time, this changed to providing more loans to government priorities in the public sector, and then universal banking products including household and SME lending. This last change was as a result of financial deregulation in Spain, and eventually this permitted the cajas to provide services both nationally and internationally. As with lots of private banks, in the 1990s and 2000s they heavily increased provisions of household credit, forming a real-estate bubble of unprecedented size in the Spanish economy (Ruiz et al., 2016). This left them massively exposed when the financial crisis came around. They were bailed out by the Spanish Government, and most of them are now merged into other banks or were taken over by the Spanish Government.

The Spanish cajas show practices that are to be avoided when setting up a public development bank. The Spanish cajas were allowed to agglomerate into one national entity, unlimited in its scope, and over time it helped to fuel a bubble in the Spanish economy. They demonstrate that governance and regulation is crucial, to ensure that any banks of this kind are defined and limited to being a local entity. They should not overextend. However, many of the problems of the cajas are down to Spanish banking regulatory practices generally rather than the original banking idea (Ruiz et al., 2016). Prior to the financial crisis, the cajas had operated reasonably successfully for over a century.

The UK

There are a number of public banking projects in the UK, some of which are licensed and fully functioning, and some of which are still in progress. Each has different objectives, sources of funding and models of operation.

The Cambridge and Counties Bank is a 'challenger bank', launched in 2012. It is jointly owned and source-funded by Trinity Hall, Cambridge University and Cambridgeshire Local Government Pension Fund. Its capital comes from these sources, as well as from customer deposits and profits. Their main objective is to stimulate SME lending in the local area, and managed to achieve a profit roughly one year after launching (making approximately £40m of loans available in that time). They focus their lending across three counties, which both spreads risk across more than one area, but also limits their scope to expand and take further risk. The German Sparkassen model adopts a similar, albeit much larger approach, spreading risk across the country but limiting individual Sparkassen bank lending to local areas. However, they differ in that the Cambridge and Counties Bank has a less explicit community objective.

There are three main known examples of projects to advance community banks in the UK (the Community Bank Savings Association, Hampshire Community Bank, and the Liverpool City Regions). The Community Bank Savings Association aims to build a network of independent, community banks across the UK. Each would be a co-operative, with one-member-one-vote for customer owners. The regional principle would be similar to the Sparkassen banks, with banks existing for the purpose of supporting a defined locality. Until recently, it was illegal for co-operatives to run banks, but this has changed in light of recent legislation. While the banks will not pool and spread risk – regulations do not permit separate banks to do this in the UK – they will pool and spread costs, using economies of scale. The banks will open branches, made up of staffed and automated services, to provide face-to-face contact and allow lending decisions based on soft information. They are primarily seeking to be commercially viable, but with an explicit community principle. They argue that a population of approximately 3 million is ideal for a viable community bank (although this is flexible). No banks have opened under this model yet, but discussions are ongoing with Greater London local authorities and other regions.

The Hampshire Community Bank is a community interest company, made up of former members of the banking industry and Professor Richard Werner from Southampton University. The bank is more explicitly based on the Sparkassen model, in that it cannot be bought or sold by anybody else, and aims to use its profits to invest in projects in the local economy and community. Its model is also influenced by the co-operative movement, with governance split between shareholders (investors) and a created charity. The bank aims to offer full banking services, including deposit taking, with SME lending a particular focus, however it will not open branches. It is funded by a group of local authorities. It was due to be functioning in early 2017, but it has yet to receive a full banking licence.

The Liverpool City Region Combined Authority is exploring starting a public bank. The main catalyst for this was the Liverpool City Region deal with the UK Government, as well as investment through the Northern Powerhouse. As well as local authorities, the project is also supported by higher education institutions in Liverpool. The model also involves the private sector, on the basis that this is key for getting a banking licence. The banking model is based on four key tenets: capital (1); technology (2); businesses case (3); and governance (4). Capital is to be achieved in three stages, with £1-£3 million being used to adopt the business case and conduct stress tests. They then estimate £15 million to be required to start the bank's functions, with £50 million required to make it fully functional in providing credit. They are still at the early stages, with an aim of getting all six city region councils on board in order to spend money from the combined authority budget. Key people involved in both the Hampshire and Liverpool projects are keen to use their model to open banks in other parts of the UK.

Future Evidence Needs

This report has looked very broadly at different forms that a public development bank might take in Wales. Each version brings with it different structures, objectives and effects. A national fund or greater state intervention in the national economy would be very different from a network of community banks. Should the Welsh Government be interested in exploring further the viability of a public development bank in Wales, research will need to be more narrowly focused. A future research project could assess how a public bank would complement existing finance institutions such as Finance Wales and credit unions (1); evaluate which particular 'failings' a public development bank would address (2); consider the applicability to the Welsh context (3); and then consider how such a bank would be implemented (4). For example, should the Welsh Government be interested in adopting the German Sparkassen model in Wales, this would require not just community banks throughout Wales, but some form of national investment bank to fund it, alongside studies of economic activity in different areas of Wales to stress test the viability of such a bank. As shown in this report, such a model could potentially succeed in Wales, but due diligence is required.

Research on the potential benefits of a public development bank in boosting SME lending is not exhaustive. Evidence from a previous PPIW study (Jones, 2016) suggests that different types of finance might be appropriate for SMEs depending on their age and their collateral. Venture capital style financing is argued to be more suitable for new firms, so that risks can be shared and pooled in much the same way as private banks, while more traditional repayable loans might be more appropriate for established firms looking to grow. Future research could explore the type of financing that different forms of public banks could provide, and the viability of applying this in Wales.

Anecdotal evidence combined with descriptive statistics suggests that bank branch closures are having a negative impact on individuals and businesses in Wales, but more specific research is needed to ascertain what impact bank branch closures is having on individuals and communities. Finding out the extent to which vulnerable areas are affected by bank branch closures can also help to identify which specific services can be provided in future.

Conclusion

This report has brought together the available evidence on public development banking, and its potential viability in Wales. It has suggested ways in which to understand what a public development bank might mean, how it would create money, and presented evidence to inform discussions of whether a public development bank could stimulate business lending and economic development. Finally, it has shown examples of public banks from the UK and across the world, and their applicability to Wales.

Setting up a public development bank, in any form, is not easy. If the intention is to merely advocate greater state intervention in the economy, then it is important to think about to what end the government wants to intervene, and whether it can be a good asset manager. If the intention is to set up a national investment bank, along the lines of the German KfW, then further research is required to determine how such finance would be directed throughout the Welsh economy, as no viable structures currently exist. If the intention is to set up a network of community banks, then extensive research is required into the most useful banking model for Wales, stress testing whether such a bank would be commercially viable, and whether funding would come from the Welsh Government or elsewhere.

However, in spite of the extensive difficulties, this report has highlighted the potential for a public development bank to benefit the Welsh economy. There is an SME lending problem in Wales, and the nature of the banking system appears to be exacerbating it. Public banks with an explicit community objective could be able to process soft information that could boost SME lending in Wales. Profits from public banks could also then be put back into the Welsh economy. Examples from around the world demonstrate the importance of good governance structures to limit political interference and overreaching, but where they have worked they have led to a more diverse banking system that better serves the various priorities of the national economy, rather than just its financial capital city.

This is an initial scoping study, and beyond recommending more specific research it is not in a position to endorse policy outcomes. The evidence suggests that there is potential for some form of public banking that can address problems in the Welsh economy and financial sector. However, introducing such a model would be very challenging and complex, and due diligence would be required on each potential model. In particular, further consideration needs to be given to the specific market failures that need addressing, and testing whether and how a public development bank might address them.

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