

Progressive Economics Group (PEG)

Policy Brief

National Investment Bank and small & medium businesses

John Marlow
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Policy Issue

The 2017 Labour Manifesto calls for a National Investment Bank (NIB) and a network of regional development banks. A £250 billion “National Transformation Fund” would be focused on infrastructure and housing, and NIB would provide £25 billion/year lending to small businesses, including coops, and to contribute to “transforming our financial system”. Meanwhile, the Scottish Government is seeking to develop plans for a Scottish National Investment Bank.

What is the appropriate organization of lending to small and medium enterprises that effectively increases their access to credit?

Analysis

Several reports have proposed public investment banking including the (now privatised) Green Investment Bank and the (still tiny) British Business Bank (BBB). More recent work by the New Economics Foundation (NEF) and others focuses on plans for Scotland and for the now state-owned Royal Bank of Scotland (RBS).

A report to the shadow chancellor contains the following proposals:

- 1) a public-equity-plus-bond-issuance financing system;
- 2) lending to commercial banks for “on-lending” to small and medium-sized enterprises (SMEs);
- 3) a governance structure overseen by national and regional supervisory boards with politicians, businesses and union representation.

Two of the Labour report’s authors have offered alternatives for NIB funding that could be combined with unconventional monetary policy.

This brief focuses on implementation and governance. It draws on experiences with lending for SMEs in the European public investment banking sector to identify the difficulties faced by the conventional “on-lending” approach. Lending to SMEs typically requires a local presence, enabling banking relationships to be built up over time. What most public investment banks actually do is to give slightly advantageous loans to commercial banks in the expectation that the latter will increase their lending to their SME clients. This is similar to the existing Funding for Lending scheme or the Bank of England’s Term Funding Scheme. As the report to the shadow chancellor states, these schemes have not substantially changed lending to SMEs.

The problem is that money is fungible; that is, it can go to many purposes. Lending to a bank for on-lending to SMEs is like pouring money into a large container out of which the intermediary bank lends to SMEs, and also buys bonds, issues mortgages, pays dividends, and carries out other financial activities. One approach is to demand that intermediary banks list of all the loans nominally issued with the public money. Another is to provide guarantees for specific SME loans. But neither approach is able to show whether supported loans would not otherwise have taken place. Monitoring changes in commercial bank portfolios might be an improvement, but that does not avoid the problem of determining what the counterfactual should be.

SME's are costly to finance, and more of these enterprises could be financed were loans cheaper, longer-term or carried fewer collateral requirements. However, evidence suggests that finance is not the binding constraint on small and medium-sized enterprises. Surveys such as the ECB's [SAFE](#) survey and [another](#) from the European Investment Bank consistently show finance among the least important concerns of SME managers.

These survey results are unsurprising given historically low interest rates and the high degree of liquidity in financial markets. As a result subsidised lending from the NIB might enable commercial banks to lend more to SMEs, but this might have limited impact. By contrast, the proposed £25 billion/year by the NIB is equivalent to around 20%-25% of current SME investment and all their current external financing. Increasing SME investment by such an amount could be a long-term policy goal. But we should not expect £25 billion a year of cheap liquidity to translate into the same increase in SME financing given the uncertain effect on bank behaviour.

Policy Framework

A public banking model in the UK should be designed to tackle shortcomings of the existing financial system. Three recommendations would help achieve that:

Target the margin: This means putting quality over quantity, focusing efforts at supporting businesses likely to encounter financial constraints and that offer high social returns, such as very small firms and coops. There is a tendency for public banks to push for eligible investment categories that are as broad as possible. For example, the term SME is sometimes interpreted to include quite large firms. This increases the likelihood that the majority of the lending just goes to companies that would have been funded in the absence of an SME programme.

Build a locally-accountable public banking service: Financial markets fail to provide locally-embedded business banking services that are essential to SMEs. This is especially the case in Britain. What is needed is to create a network of local, public service-oriented banks, similar to the *Sparkassen* in Germany. The [Banking for the Common Good](#) proposals for a network of People's Banks, closely linked with local credit unions and other mutual institutions in Scotland, is exemplary in this regard, as are the NEF's [proposals for the future of the RBS](#).

Other forms of local accountability: Standard governance practice for state investment banks involves political oversight via a supervisory board, with operational control left to a managing board of appointees, typically from the banking sector. Designed to prevent political interference and leave operational matters to professionals, such systems are not always entirely effective. The above proposals for local bank networks include a governance arrangement with local government, employees and other local stakeholders each making up one third of the representation on the supervisory board. This stakeholder approach should also be replicated at the national level, with the NIB accountable to national and regional governments, employees and the local bank network it would serve.