A question OF SIZE

Widespread bailouts of the major banks in 2007-08 and the threat of post-crisis break-ups saw attentions turn to the importance of small banks in the local economy. PHIL MOLYNEUX reports.

In recent years, banks have become larger, driven by market power, scale economies and too-big-to-fail motives. Small banks often have limited access to government safety nets and typically focus on financing individuals and households as well as small to medium-sized enterprises (SMEs).

Evidence exists that small banks with limited market power reduce SME financing constraints. Healthy small banks improve SME financing, and findings indicate that types of financial sector development promote small firm growth. It has been proven that small regional institutions can prevent capital outflows and promote local economic growth in underdeveloped regions, whereas the bigger banks have been linked to greater regional economic imbalances. These conflicting views raise questions about the role of bank size on firm-financing and economic development.

ECONOMIC IMPLICATIONS

Recent work undertaken by researchers at Bangor University has sought to examine the impact of small banks on economic development. The work focuses on the German banking system as there are many more small banks located here and these are often local and/or regional in nature. German data is used because the country has a strong local banking sector, namely savings banks (Sparkasse) that follow a regional principle. They operate predominantly within their own area and typically do not compete with others savings banks. The regions in which the savings banks operate are easily identifiable and are closely linked to German administrative districts, called counties (Kreise). Counties are the second-smallest administrative units that provide macroeconomic data on a regular basis. Therefore, a focus on Germany yields financial and macroeconomic data on a disaggregated level.

Through a variety of modelling approaches the research found that:

- a higher level of bank profitability spurs a region's economic development
- efficient small banks help spur regional economic growth

REGIONAL DEVELOPMENT

It is interesting to consider whether these relationships hold in both rich and poor regions. If small banks can prevent financial resources (depositors and lenders) flowing from poor to rich areas, then these organisations will help cover local capital demand, meaning the impact of efficient small banks should be stronger in poorer regions. Our research found this to be the case – efficient small banks operating in poorer regions aid development more than similar banks operating in rich regions.

Overall, the findings suggest that the presence of savings banks as regional funding providers is positively associated with local economic growth and this effect is stronger in relatively poor regions. Small banks appear to be important funding providers in these areas and as such they may limit capital flows from poor to rich regions – results which are consistent with our theoretical model.

SCALING THE IMPACT

The research asked another key question: does bank size have a differential impact on a region's economic development? Bangor researchers looked at the branch market shares of regional savings banks, regional cooperative banks and big commercial banks in Germany. They found that regions which have a larger market share of savings banks have higher growth in new business registrations – suggesting more prosperous economic conditions. As the growth rate of regional business registration mainly represents SME growth, these results confirm earlier work which shows that small banks are more effective in promoting SME

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development. Findings for large commercial banks, however, indicate that a greater presence of branches in a region does not seem to improve regional development.

This may be due to the fact that the presence of large commercial banks can crowd out small banks that have a stronger focus on local SME finance. In fact, larger banks have a more positive role on local economic development in rich regions as opposed to poorer counterparts.

CONCLUSION

The potential role of small banks in a financially-integrated market is not obvious. Earlier studies suggest that local financial development remains important and there is a key link between local financial development and economic growth. In a financially-integrated market, capital will flow from poor to rich regions. As a result of the lower level of economic activity, an expansion in investment will have a rather high marginal productivity in poor regions. Small banks play an important role in local economic development and will have a larger impact on economic growth in poor regions, as they can be effective in preventing capital outflows from poor to rich areas.

These results illustrate the crucial role small banks play in a financially-integrated market. Inter-regional bank consolidation may destroy the regional foundation of these banks, turning small regional banks into big banks and thus losing the potential benefits. Policy that supports small banks will prevent a capital drain and foster development, especially in less developed regions. CB

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