IAT DISCUSSION PAPER

18|03

The Banking Systems of Germany, the UK and Spain from a Spatial Perspective: The UK Case

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July 2018

Summary

As expected, this comparison of the German and the UK banking systems shows substantial differences between the countries. In the UK, savings banks disappeared long ago and other regional banks have never become important in lending to business. Instead, the five large commercial banks dominate business lending. Hardly any short-distance lenders still currently exist in the UK according to our qualitative distance classification of banks and other financial providers for small firms. The closure of the very last local savings bank in 2017 marks the preliminary end of traditional regional banking in the UK and indicates that the financial crisis indirectly challenges small and regional banks disproportionally. This is because the low interest rate environment and more complex banking regulations affect small and regional banks more, making it almost impossible for small standalone banks to survive. Problems in small firm finance have been discussed in the UK at least since the 1990s and government support has been given to community development financial institutions and credit unions in order to close the financial gap for small firms. Due to the financial crisis, access to finance has become increasingly difficult for small businesses, especially in remote regions, so the debate on how to reinvent local banking (and hence how to improve access to finance) has gathered momentum. Three options are under discussion. The first is to create in one stroke a regional and public banking group with a substantial market share by restructuring the Royal Bank of Scotland into a network of local and public banks. The second is to re-create regional banks on an entirely new basis with the help of a new association that would provide economies of scale and knowledge in order to enable local people to create their local banks. The third is to establish local banking by upscaling other financial providers, such as credit unions and responsible finance providers. Whether any of these options are realistic is difficult to say right now. One additional option that could improve SME finance are the so-called challenger banks, a type of bank unknown in Germany. These banks differ in terms of ownership, business model and regional market orientation, yet our findings suggest that they tend to operate on a more decentralised (short-distance) business model than large commercial banks.

Keywords: comparing banking systems, SME finance in the UK, decentralised vs. centralised banking

JEL classification: D43, E21, G01, G21, G38, R12

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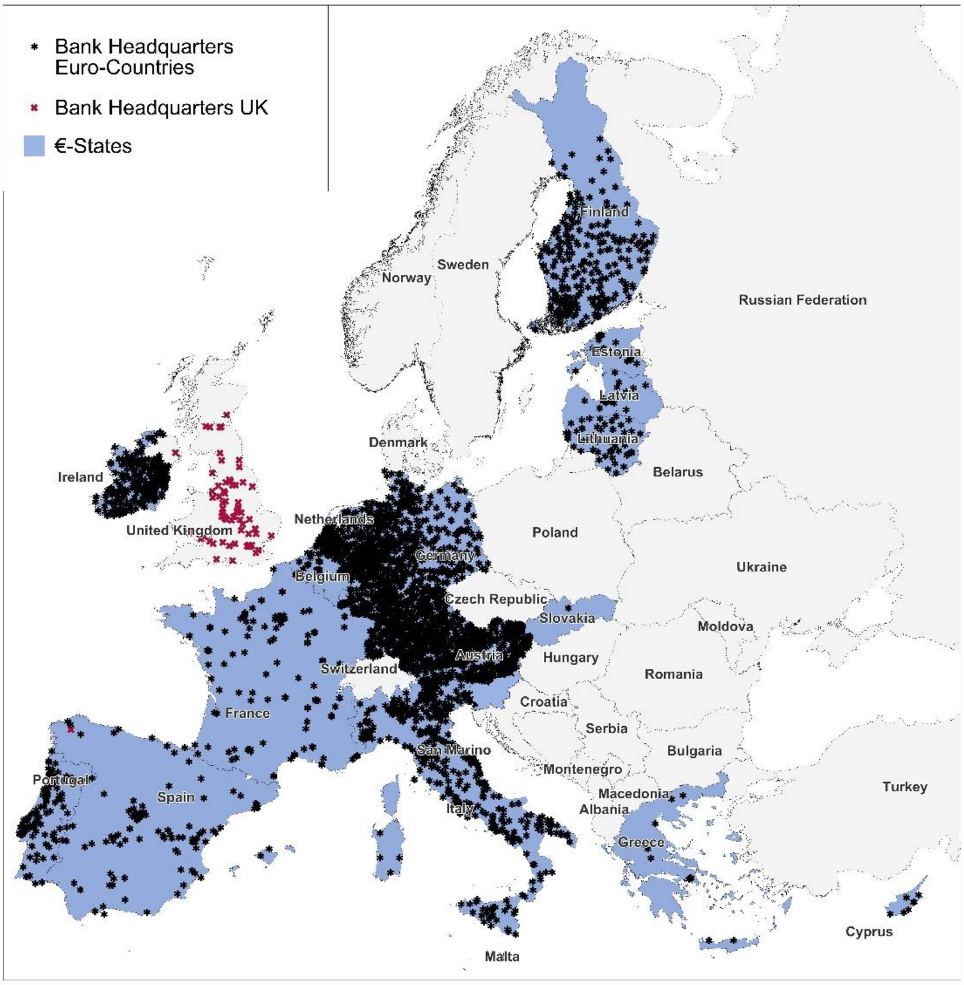
A: Introduction

Despite the initiatives to create a common European financial market, the banking systems of the European States vary, especially with respect to the spatial concentration of banks and other financial institutions (Klagge and Martin, 2005; Gärtner and Flögel, 2014; Wójcik and MacDonald-Korth, 2015). Map 1 shows substantial differences in the spatial allocation of bank headquarters for the Euro countries in 2014 and the UK in 2017. Austria, Germany, Ireland, Italy and the Netherlands have a rather decentralised allocation of headquarters. In contrast, France, Spain, Belgium and the UK are seen to be rather centralised in terms of bank headquarters. The existence or non-existence of regional banks tends to account for the visual difference between the European states that is apparent in Map 1. This paper investigates the diversity of the national banking systems of Europe from a spatial perspective by looking at decentralised and centralised banking (Gärtner and Flögel, 2014; 2017). It is one of three papers of a research project sponsored by the Hans Böckler Foundation that compares Germany (Flögel and Gärtner, 2018), the UK and Spain (Gärtner and Fernandez, 2018). This paper discusses the development of the UK banking system and compares it with Spain and Germany, focusing on lending to enterprises by banks and other financial providers in the UK. In this context, we trace the disappearance and possible (re)establishment of regional banks. The rest of the introduction outlines the conceptual and methodological foundations of the research project.

Map 1: Bank headquarters locations in the Euro countries in 2014 and the UK in 2017



Authors' map, source: ECB (2014), Bank of England (2017)

The diversity of banking and financial systems is apparent when we look under the surface. Traditionally, the structure of financial systems is approached by distinguishing between bank- and market-based systems (Allen and Gale, 2001; Demirgüc-Kunt and Levine, 2001; Hall and Soskice, 2001). However, misgivings about the suitability of this classification have emerged since the financial crisis of 2008 (Beyer, 2009; Hardie et al., 2013). There is a whole range of alternative taxonomies and concepts for distinguishing between financial systems (for an overview, see Gärtner, 2013). For example, Gowan (2009) outlines differences among public utility versus capitalist credit and banking systems. Differentiations between Islamic and non-Islamic financial systems are also discussed, linked to the question of whether or not generating interest income should be allowed (Pollard and Samer, 2007). Hardie and Howarth's classification (2013) examines differences in banks' lending practices in relation to their dependency on capital markets. The authors distinguish traditional banking from market-based banking and emphasise that under the market-based banking model, banks' lending decisions actually depend on capital markets. Whilst appreciating these approaches, we see one additional distinctive feature of financial and banking systems: their spatial arrangements, relating to the importance of decentralised banking compared to centralised banking.

As early as 1995, Klagge argued in favour of a classification of banking systems into decentralised and centralised systems (Klagge, 1995), so our approach picks up an ongoing debate (Verdier, 2002; Klagge and Martin, 2005; Gärtner, 2011; Gärtner and Flögel, 2013, 2017; Klagge et al., 2017). In our view, there are two important and related characteristics that define decentralised versus centralised banking and banking systems (Gärtner and Flögel, 2014):

The first is the *geographical market orientation* of banks' business activities. Do banks operate on a regional level, such as by collecting money from regional savers and handing it to regional borrowers, or do they rely on business at the supraregional scale, whether by borrowing and investing in national or global capital markets or by operating supraregional branch systems (regional vs. supraregional banks)? The theoretical foundations here lie in polarisation and post-Keynesian theories on regional banking markets and interregional flows of capital (Chick and Dow, 1988; Dow and Rodríguez-Fuentes, 1997; Klagge and Martin, 2005; Gärtner, 2008). In particular, the ability of regional banks to slow capital drains from the periphery to core regions, which is heatedly debated, suggests that regional banking may make a difference when it comes to access to finance in peripheral regions and, hence, stimulate more balanced regional development (Gärtner, 2008).

The second characteristic is the *place of decision-making.* Do banks decide in proximity to their clients (such as whether to grant a loan) or are decisions made from a long distance, for example in remote headquarters (short vs. long distance)? Decentralised banking capitalises on proximity between creditors and borrowers in order to conduct investment or lending decisions. From a theoretical point of view, lending at proximity to borrowers is associated with reduced information asymmetries and reduces credit rationing, especially when lending to small- and medium-sized enterprises (SMEs) (Stein, 2002; Pollard, 2003; Berger et al., 2005; Gärtner, 2009b; Alessandrini et al., 2009; Flögel, 2018). The relevance of difficult-to-transmit so-called soft information in lending to informationally opaque SMEs restrains decision-making at a distance, such as in financial centres, and favours a decentralised banking system in which banks' head offices and decision makers are located in proximity to their clients. In contrast, centralised systems capitalise on proximity between the financial institutions themselves in order to facilitate financial innovation and organise and control investment decisions indirectly. As a consequence, financial institutions need geographical proximity to other banks, rating agencies, lawyers, regulatory bodies and other actors, which explains the rise of financial centres (Friedmann and Wolff, 1982; Friedmann, 1986; Sassen, 2001; Taylor et al., 2003; Lo, 2003; Grote, 2004; König et al., 2007; Hall and Appleyard, 2009; Schamp, 2009; Therborn, 2011; Gärtner, 2013; Dörry, 2015).

Against this conceptual background, the core element of this research project is to compare decentralised and centralised banking in the three European countries of Germany, Spain and the UK. In line with the Varieties of Capitalism (VoC) research tradition (Hall and Soskice, 2001; Schmidt and Tyrell, 2004a; Hackethal et al., 2006; Dixon, 2012), our research questions are twofold. On the one hand, we raise the question of how decentralised and centralised banking systems influence access to finance, especially for

SMEs, and thus influence regional development, meaning how financial intermediaries could contribute to balanced regional development. On the other hand, we address the influence of the broader economic, social and political context on the development of banking systems. Here we try to identify causes of the development of decentralised and centralised banking systems. In doing so, we discuss the influence of banking regulation and other national and international policies, advances in information and communication technologies (ICTs), the degree of centralisation of the political system and the role of banking associations. To be clear, the intention is not only to identify reasons why regional banks exist, but also to ask whether or not regional banks can actually conduct decentralised banking amidst unifying (international) banking regulations and the ubiquitous use of ICTs in banking, especially the application of rating systems in lending to SMEs (Gärtner and Flögel, 2013; Flögel, 2018).

The three country cases of Germany, Spain and the UK were selected because they putatively show substantial variety concerning the centralisation of banking. Germany stands for a decentralised banking system that has more than 1,500 regional and economically autonomous banks, of which the vast majority are savings and cooperative banks (Gärtner, 2008; Gärtner and Flögel, 2013). Importantly, when conducting the comparison, we had to consider that Germany's decentralised and public banking system is a logical result of the specific regional structure of the Federal Republic of Germany. Savings banks have tended to be privatised in centralised countries (like France), but have remained (mainly) public in countries with a federal structure such as Germany and Switzerland (cantonal banks) (Verdier, 2002). The decision in favour of privatisation in France and Italy was taken by the central government, whilst in Germany and Switzerland it would have to be taken by the federal states or cantons (Hakenes and Schnabel, 2005: 22). The UK, on the other hand, exemplifies a centralised system, with London as one of the most important international financial centres in the world. The degree of centrality of Spain's banking system could be considered somewhere between Germany's and the UK's. Spain also provides an outstanding example for research, as the former regional savings banks have been freed from their geographical restrictions since 1988, causing a decline in decentralised banking (Gärtner and Fernandez, 2018).

We conducted our country comparison via various methods. We analysed aggregated data, especially central bank statistics, as well as individual data from selected banks and other finance providers. However, the results are quite heavily based on qualitative work, meaning qualitative interviews. For the empirical enquiry in the UK, a research visit to the Centre for Urban and Regional Development Studies at Newcastle University was conducted from August to September 2016, kindly hosted by Professor Jane Pollard. Overall, we conducted 12 interviews with banking practitioners and researchers in England and Scotland. The UK paper also makes use of existing studies, a feasible approach because access to finance in the UK, especially for SMEs in peripheral regions, is subject to a lively debate (for example, see Klagge et al., 2017).

Each of the country reports differs, as their corresponding historical paths and overall economic systems are very distinct. Furthermore, since there is no appropriate data from one common database (e.g. ECB-Data), we have to use different national data to approximate the aspects we need. Moreover, access to interview experts differed between the countries considered. The three country reports are therefore structured differently. In order to gain an overview of an overall structure that also enables comparison, each country report is structured in three parts following this introduction (Part A). Part B introduces the reader to the structure of the banking system in question. Part C explores the decision-making process of exemplary banks and part D summarises the results. For the UK, we focus on the debate over how a regional banking system could be (re)established, for Spain we discuss the requirements of decentralised banking in a broader sense and for Germany we address the recent challenges of decentralised banking.

B. The UK banking structure

In line with recent publications (Appleyard, 2013; Cable, 2014; Lee and Brown, 2017; Klagge et al., 2017), the history of banking in the UK is the history of the concentration and centralisation of banks and complaints about poor access to credit, especially for SMEs, newer firms and enterprises in peripheral regions. And in fact, regional dual bottom-line institutions with non-private ownership (Schmidt, 2009), meaning savings and cooperative banks, have almost disappeared and the four largest banks (conducting retail business in the UK) held a market share of 90% of business loan volume in 2013[3]. Nevertheless, new banks and bank-like organisations have developed below the surface of the dominant mainstream banks. This section traces the development of banking in the UK by looking at banking structure and policy (Section 1). Section 2 introduces the reader to business lending and portrays different categories of providers for business finance. Deviating from the other country reports, we extend the analysis to other (non-bank) finance providers in the UK due to the limited diversity of the banking structure, meaning the non-existence of a savings banks pillar and the limited relevance of cooperative banks for business finance. Section 3 turns to financial centres and banking associations and demonstrates the spatial concentration of banking in the UK and in terms of banking associations.

1. Banking structure and policy

Well before the financial crisis, the concentrated banking market in the UK had long been criticised for failing to provide adequate services in poorer districts and peripheral regions, and for certain sections of the population. “The withdrawal of banks (…) from poorer areas may make commercial and shareholder sense for the companies involved, but it effectively produces areas of financial exclusion” (Martin, 1999: 21). In the late 1990s, the UK Treasury commissioned a report (the highly regarded Cruickshank report) that found a lack of access to finance, above all for SMEs (Cruickshank, 2000). There were also entire districts and regions with no access to financial services (Martin, 1999: 20ff.). Compared with Germany and Spain, one key specific feature of the UK is the non-existence of banking groups or categories of banks. The Bank of England only distinguishes between UK banks and foreign banks, meaning other banks from the EU, the US, Japan and other developed countries (Bank of England, 2017). However, there are no categories like savings banks, cooperative banks, regional banks and so on.

In 2017, there were 364 banks or, more precisely, monetary financial institutions (MFI) operating in the UK. Of these, 117 were UK banks and the other 247 were foreign banks. In order to contextualise these numbers, Table 1 displays a comparison of the number of banks and branches between Germany and the UK. Germany has 2.25 banks per 100,000 inhabitants, which explains the existence of around 1,000 cooperative banks and approximately 400 savings banks. The UK has 0.56 banks per 100,000 inhabitants. The fact that London is the leading financial centre in the world with many international banks indicates that fewer domestically focused banks per 100,000 inhabitants actually operate in the UK. Accordingly, when it comes to banking services to the domestic economy, a simple comparison of the number of banks tends to support the assertion that the banking market in the UK is highly concentrated (Cruickshank, 2000; Cable, 2014). The disappearance of all relevant groups of regional and/or dual bottom-line banks predominantly caused the high concentration of banking in the UK.

[3] Loan volume for England and Wales.

Table 1: Number of banks and branches in Germany and the UK

	Number of banks	Banks per 100,000 inhabitants	Number of branches	Branches per 100,000 inhabitants
Germany (2013)	1,827	2.25	36,287	44.79
UK (2017)	364	0.56	8,500 (the 12 largest banks)	13.28

Authors' table, sources: Bank of England 2017; Deutsche Bundesbank 2014; Statista 2017; ECB 2016;

To trace the disappearance of the dual bottom-line banking pillars, one has to go back in time. Like in Germany and Spain, the banking system of the UK used to have a savings banks pillar. Aiding the poor by encouraging savings for bad times was the mission of the first savings banks in the UK and Germany alike (Brämer et al., 2010; WSBI, 2017). The first savings bank, the Parish Bank in Ruthwell, Scotland, was established in 1810. Savings banks in the UK were Trustee Savings Banks (TSBs). Voluntary trustees, usually upstanding members of the local community, such as aristocrats and clerics, oversaw the running of the banks (WSBI, 2017). Encouraged by supportive government regulation, savings banks quickly spread in the UK and their number rose to 645 by 1861. At the same time, the Savings Banks Acts restricted business activities to the safe and central investment of the clients' deposits, especially in government bonds (Batiz-Lazo and Maixe-Altes, 2006). It was the 1976 Trustee Savings Banks Act that allowed savings banks to offer the same services as commercial banks, including lending, whereupon personal lending was introduced in 1977. At the same time, the Act demanded a reduction in the number of banks in order to enhance the competitiveness of the savings banks. The 16 remaining savings banks merged into a unit in 1983 in preparation for flotation on the London Stock Exchange, which took place in 1986. Only the Airdrie Savings Bank refused unification and remained an independent and local Trustee Savings Bank until it closed for business in 2017. Similarly, the natural building and loan societies in the UK petered out due to the liberalisation of their business activities, which led to M&A and demutualisation. Not a single demutualised building society survived until 2014 and most remaining mutual building societies were amalgamated (Coble, 2014). Nonetheless, the mutual lenders held over a 20% market share in outstanding mortgages in 2017 (BSA, 2017), though they were much less significant in business lending (BBA, 17 August, interview).

Today, the UK government is trying to improve access to finance for SMEs. Vince Cable, the former secretary of state for business, innovation and skills and leader of the Liberal Democrats, described the dilemma of UK banking regulation in a speech (Cable, 2014: 85): "On the one hand, we are wanting the banks to lend to business, because how else do you get growth and recovery? But on the other hand, the banks are retrenching and they are retrenching under pressure from the regulators who want them to hold more capital, who want them to sort out their balance sheets and reduce their risk. And they are contradictory objectives." In order to overcome this dilemma, the government promotes competition by supporting new providers of firm finance. These providers are the so-called challenger banks, the credit unions and the so-called responsible finance providers and crowdfunding/peer-to-peer lending platforms (out of which only challenger banks have a MFI licence in the UK). Furthermore, the British Business Bank was founded in 2014 to improve access to finance for small firms (Van der Schans, 2015).

The idea behind the British Business Bank was to establish a development bank (meaning a special purpose bank) like the KfW in Germany. The UK was one of the few developed countries that did not have such a bank (van der Schans, 2015). However, according to the experts we interviewed, the British Business Bank only performs as a government-sponsored special purpose bank to a certain extent (BBA, 17 August 2016, interview; RSA, 16 August 2016, interviews). Its substituted loans and guarantee schemes are rather small scale as compared to German standards. For example, the "Enterprise Finance Guarantee", a 75% guarantee scheme for business loans, only supported 27,000 loans to a value of £2.8 billion between 2009 and 2016 (Van der Schans, 2015; British Business Bank 2017a). Although this guarantee scheme supports lending, its extent and stimulating effect are limited in the estimation of the interviewed expert from the British Bankers Association (BBA) (BBA, 18 August 2016, interview). In this context, the British Business

Bank targets its mission, the stimulation of (small) business finance, by other means. It provides information and market intelligence and supports alternative finance, such as by sponsoring peer-to-peer lending platforms.

Since the late 1990s, the government has given support to responsible finance providers (such as community development financial institutions) and credit unions aimed at closing the financial service gap. These include various types of non-profit financial intermediaries, in some cases local initiatives, which offer financial products such as micro-lending suited to very small businesses and poorer sections of the population (Collin et al., 2001). Similarly to the development in Germany (Flögel et al., 2018), the government has altered its support for small firm finance and reduced subsidy schemes with the intention of professionalising the micro-finance market. We trace the developments of business lending in the UK in the following section by taking banks (MFIs) and other financial providers into consideration.

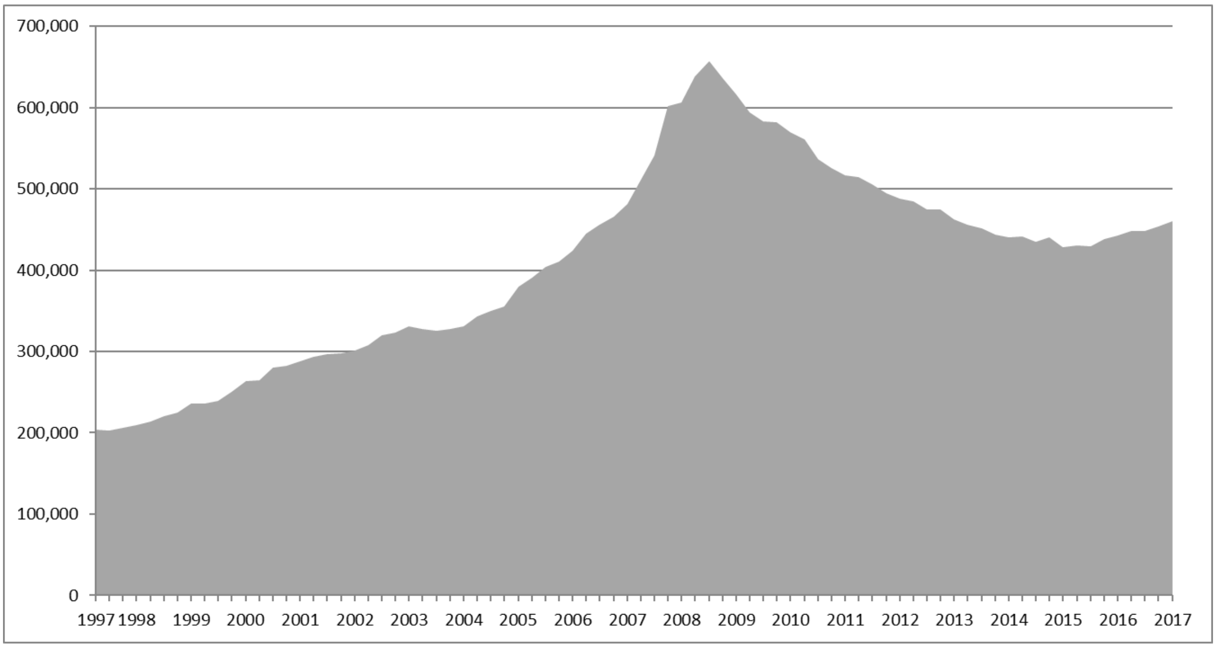
2. Business lending by categories of banks and other financial providers

The following sub-sections introduce the reader to the different categories of banks and other providers of business finance, clarifying their position and importance for small firm finance in the UK.

Large banks (the big five)

Cable (2014) and several interviewed partners (RSA, 16 August 2016, interview; RFP, 12 September 2016, interview) see the long period of declining credit since the financial crisis of 2008 as evidence of the insufficiency of the UK banking system. Figure 1 reports the credit volume of MFIs to the non-financial industry in the UK between 1997 and 2017. A continuous decline in credit volume between 2008 (the lending peak) and 2015 (the lowest value since the financial crisis) becomes visible, meaning that banks reduced credit volume by £227,558 million (-35%). Since 2015, credit volumes have risen again. Despite the fact that the lending figures support criticism of the UK banking system, one must also recognise the strong increase in lending, especially on the eve of the financial crisis. Against this background, Hardie and Maxfield (2013) argue that the market-based financial system has changed in the UK, as lending has become more and more important for corporate finance. However, lending banks do not act like traditional (patient) banks, but conduct market-based banking, meaning that they depend heavily on the financial market in their ability and willingness to lend. Accordingly, Hardie and Howarth (2013) expected substantial cyclicality of market-based lending, with excessive lending in good times and strong credit cuts in bad times (see also post-Keynesian theories on cyclicality, Chick and Dow, 1988; Minsky, 1992), as seen in the UK in the financial crisis.

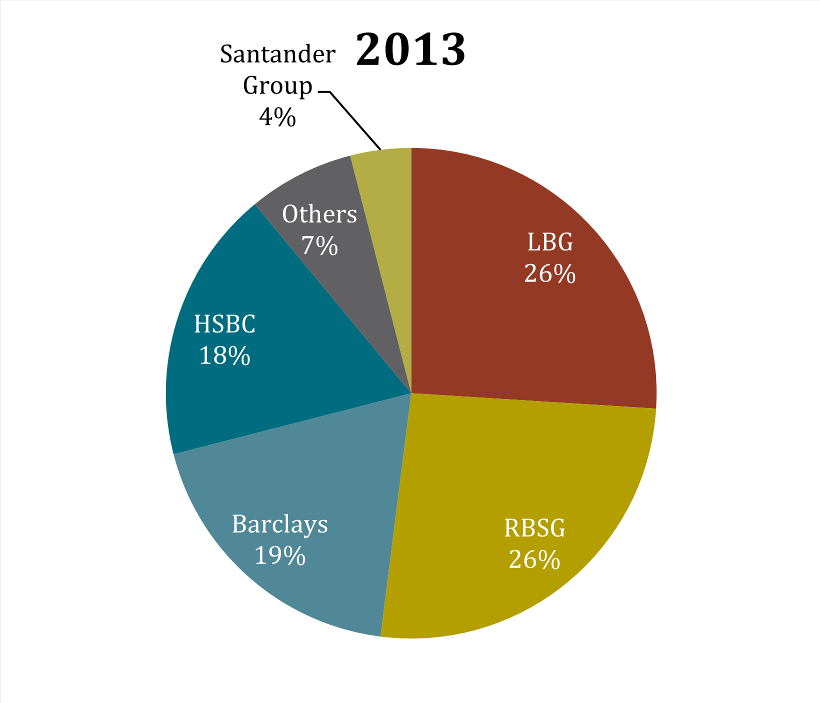
Figure 1: Credit to the non-financial industries in millions of pounds



Authors' figure, source: Bank of England 2017

Gärtner and Flögel (2015) outline how regional savings and cooperative banks slowed down credit cuts in Germany after the financial crisis as they increased lending, whereas the four big banks cut lending, as did the Landesbanken. As the Bank of England does not provide information on lending by categories of banks, one cannot say for sure that the UK's large commercial banks account for the decline in lending during the financial crisis. However, their dominant position in business lending does suggest the conclusion. In 2013, business lending was dominated by four large international banks in the UK (Figure 2). The Royal Bank of Scotland Group (RBSG) and the Lloyds Banking Group (LBG) each had a market share of 26% in terms of loan volume, followed by Barclays (19%) and HSBC (18%). The LBG includes the former TSBs, which merged with Lloyds Bank in 1995. The RBSG has been majority-owned by the state since their bailout in the financial crisis (Greenham and Prieg, 2015). Santander UK, the UK subsidiary of the Spanish Santander Group, is in fifth place in terms of business loans. Santander has a considerable branch network in the UK following the acquisition of several UK banks in 2010.

Figure 2: Volume shares of business loans in England and Wales[4]



Source: British Business Bank 2016

Challenger banks

In order to improve business lending in the UK, the government and related organisations put their confidence in new competitors, the so-called challenger banks (Cable, 2014; British Business Bank, 2015). "Challenger banks include new entrants to the market, spin-offs or disinvestments from large banks and existing smaller banks seeking to grow" (British Business Bank, 2016: 77). Whereas challenger banks operate in several business areas, a number of banks like Aldermore, Shawbrook, Cambridge & Counties Bank and Handelsbanken focus on SMEs in particular. These new challenger banks, particularly the Swedish Handelsbanken, have a reputation for being more supportive of SMEs and are keener to maintain Hausbank relationships with clients compared to the big five commercial banks (RSA, 16 August 2016, interview). Their market share in business lending is still small. Clydesdale, one of the largest challenger banks, reported a business lending portfolio of £7.1 billion in 2015 and Aldermore reported £2.2 billion in 2014 (British Business Bank, 2016: 77), and accounted for approximately 20% of all SME lending in 2016 (British Business Bank, 2017: 81). Expectations for the forecasted rapid growth of challenger banks were tempered by the British Business Bank in its 2017 report on small business finance (British Business Bank, 2017: 81). Following the EU referendum, one challenger bank has revised its plan to grow because of the resulting economic uncertainties.

Regional savings banks

When comparing the development of savings banks in the UK and Spain with Germany, differences in their engagement in private and business finance become apparent. As outlined, banking regulations allowed savings banks to lend in the UK in 1976. In Spain, savings banks were allowed to offer the same services as commercial banks starting in 1977 (Gärtner and Fernandez, 2018). Before this liberalisation, savings banks in both countries essentially used to collect smaller deposits and invested the savings in the

[4] In Scotland and partly in Northern Ireland, other banks have a dominant position in SME lending, so the concentration is comparable to England and Wales (Löher and Schröder, 2018).

government or similar safe investments with the intention of protecting the deposits of the poor from default on risky assets like business loans. In contrast, savings banks in Germany were founded as publicly supported self-help organisations in the 19th century, not only to help the poor to save, but also to support small local firms with loans (DSGV, 4 March 2013, interview). Hence, lending to small firms and private individuals has always been a business segment of Germany's savings banks. Here, the large commercial banks were latecomers as they targeted small private and business clients only after the Second World War (Gall et al., 1995; Historische Gesellschaft der Deutschen Bank e.V., 2009; DSGV, 4 March 2013, interview). As discussed in the introduction, lending at a short distance to clients is one advantage of regional banks. Regional savings banks in the UK were only able to make use of this advantage when permission to lend was granted in 1976 and only Airdrie Savings Bank resisted the mergers and privatisation of the 1980s, making it a prominent example of a historical regional bank in the UK.

Established in 1835, **Airdrie Savings Bank** was the only remaining local TSB in the UK until it closed in April 2017. The CEO of Airdrie Savings Bank, whom we interviewed in September 2016, only months before the bank declared it was closing, cited the bank's establishment under the 1919 Scottish Savings Bank Act as one reason why Airdrie Savings Bank remained independent, unlike the other local TSBs. After 1835, the UK's central government enacted legislation requiring all savings banks to hold assets centrally with the state. Airdrie Savings Bank decided to remain under the old law "because the trustees' feeling was that the funds raised locally are being spent locally", wherefore local investments were permitted (Airdrie Savings Bank, 7 September, interview). Still, Airdrie started lending to customers only in the 1980s. Before that, it collected money locally and invested it in government bonds and gilts.

During our interviews in 2016, the savings bank had three branches (four branches had already been closed) and around 70 employees. It operated approximately 30,000 accounts and 1,800 business loans. The financial statements of 2013 reported total assets of £158 million (Airdrie Savings Bank, 2013), indicating that Airdrie Savings Bank was much smaller than German savings banks, whose average assets were roughly €2.6 billion in 2013 (Gärtner and Flögel, 2017). Also, the allocation of assets differed from German savings banks, as lending to customers only made up around 33% of all assets (other important assets were loans and advances to other banks, depth securities and government bonds) (Airdrie Savings Bank, 2013), reflecting Airdrie's late engagement in customer lending. Well aware of its difficult portfolio structure in times of low interest rates, Airdrie Savings Bank tried to stimulate small firm lending (where the bank gained the most profit) and hired two new credit officers, in addition to introducing a new back-office system to boost efficiency (Airdrie Savings Bank, 7 September, interview). Explaining why it was closing down, the savings bank named the highly competitive market in the low interest rate environment and ever-rising operating costs, caused partly by more complex banking regulations, which the small bank was no longer able to carry on its own. In order to prevent bankruptcy, the bank began a phased end to business activities in the interest of its customers (Airdrie Savings Bank, 2017).

Credit unions and responsible finance providers

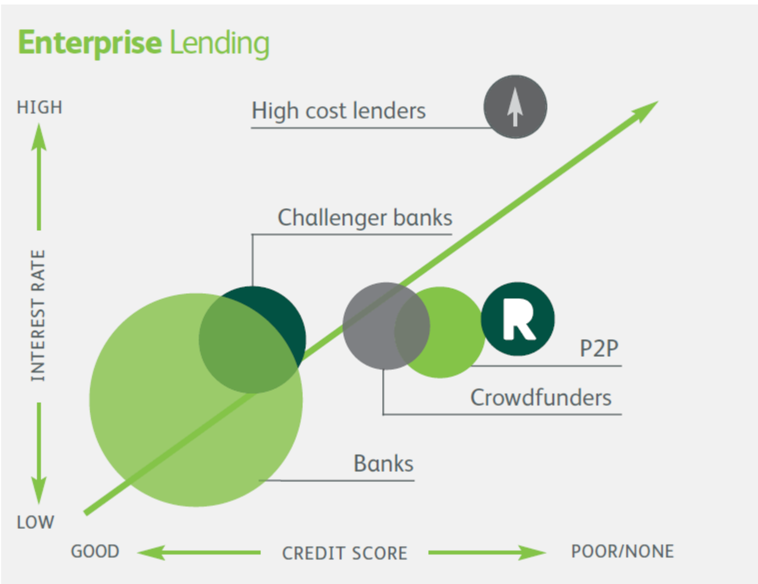
Credit unions are community-based mutual societies "run as financial co-operatives" (Muqtadir 2013: 1). Today's credit unions spread to Great Britain in the mid-1960s, when credit unions from Ireland were copied in Scotland (academic expert, 7 September, interview). Like 18th-century mutual societies, credit unions were established to help their members by tackling financial exclusion. Traditionally, credit unions are founded by members with some common bond, such as an ethnic group in a community, and business is conducted by volunteers (academic expert, 7 September, interview). In 2013, there were 390 credit unions in the UK, with 1.04 million members and total assets of £957 million (Muqtadir, 2013). Although most credit unions are rather small and often still managed by volunteers, a trend of upscaling has become visible, especially as unions merge into larger entities. This is in line with the interests of the UK government, which is trying to support and professionalise credit unions in order to reduce financial exclusion (BBC News, 2008). New regulations have relaxed the common bond requirements, enabling credit unions to target a broader customer or member base, allowed lending to business and social enterprises (in

2012) and set new standards for reporting and supervision. There is concern about whether these new regulations endanger the community-based self-help ideology of credit unions and particularly overburden small and voluntarily-run institutions. Besides their earnings from interest and fees, many credit unions also attract government subsidies (from the municipal to the EU level) in order to run the business and provide financial education (academic expert, 7 September, interview). As such, credit unions typically help their clients to work their way out of excessive indebtedness.

Another group of small-scale lenders are **responsible finance providers** (RFPs), who directly address micro-businesses and small businesses with their services. Previously community development finance institutions (referring to the US role model) RFPs were renamed in 2015 in order to respect their extended focus (RFA, 1 September, telephone interview). Unlike credit unions, RFPs do not take deposits from clients, but rely on government schemes (from local authorities to the EU level) and private money (including commercial bank loans) to refinance their loan books. In 2016, around 60 RFPs were members of the responsible finance association (RFA). In addition to the business lenders, a mix of personal and social lenders also belong to the association. According to survey data of the RFA, in 2016 the responsible finance sector provided £242 million of credit, of which £103 million went to 9,600 small businesses (RFA, 2017). This represents a £5 million increase in business lending as compared to 2015, so overall lending fell by £9 million (RFA, 2016).

We interviewed the CEO of the RFA and the CEO of one medium-sized RFP, located in the south of England. Both interview partners mentioned that finding central-government and EU funding was becoming increasingly difficult because of changes in the schemes (particularly the end of the regional growth fund) and the Brexit. Therefore, the RFPs aim to become more self-sufficient and increase non-public funding (RFA, 1 September, telephone interview; RFP, 12 September, interview). However, becoming self-sufficient is challenging because RFPs target more risky and small business clients in order to fill the funding gap (Figure 3). The higher default risk, small loan size, and labour-intensive screening and monitoring of this group of borrowers imply low profitability in this market. In this regard, RFPs can be compared with micro-finance institutions in Germany, which also depend on government schemes in order to conduct business with risky micro-enterprises (Flögel and Gärtner, 2011; Flögel et al., 2018).

Figure 3: Enterprise lending in the UK from the perspective of the RFA



Source: RFA 2016: 30

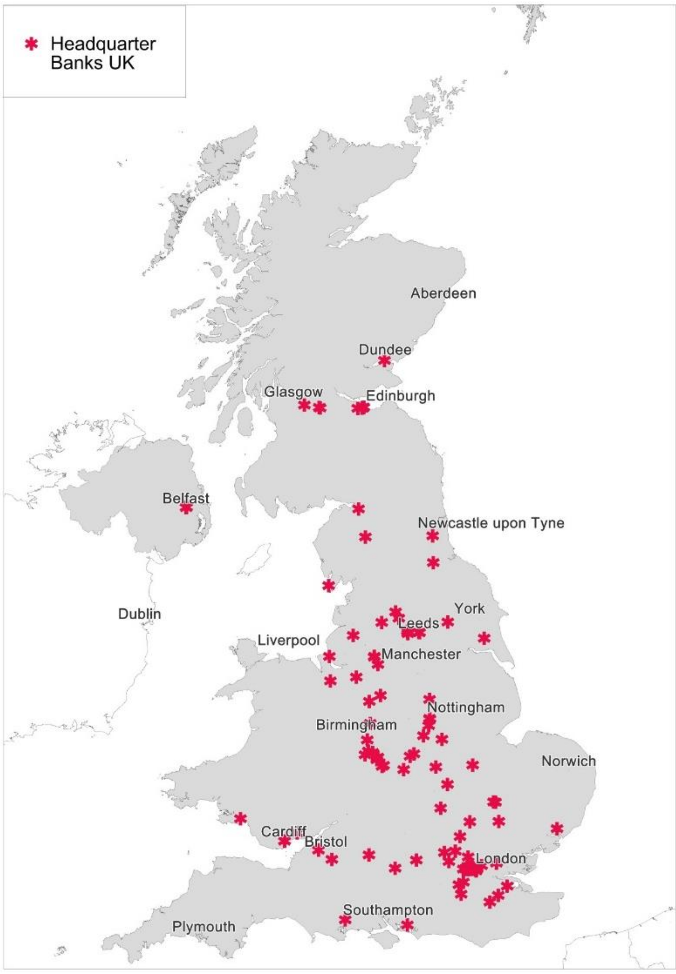
3. Financial centres and banking associations

As described in the introduction, we distinguish between decentralised banks, which benefit from close relationships to their customers, and centralised banks, which benefit from close relationships with companies within the financial value chain. The role of proximity is important for both of them, but at different points of the value chain. Decentralised banking suggests a decentralised allocation of banks and other financial institutions. However, the decentralised location, remote from the financial centres, implies the disadvantage of a lack of proximity to other banks, rating agencies, specialised lawyers and so on. This poses the risk of a lack of specific (financial) knowledge, skills and access to services. In contrast, centralised banking is associated with the development of financial centres, where intensive flows of knowledge between the co-located organisations occur at the price of distance to remote clients and regions. Close cooperation of decentralised banks in banking associations[5] can overcome the remoteness of peripheral banks and give them access to the banking knowledge and skills available in the financial centres. This section discusses the centralised structure of the UK's financial centres and introduces the reader to the banking associations of the UK.

The following maps depict the location of bank headquarters in the UK (Map 2) and London (Map 3). Of the 364 banks, 271 or 74% have their headquarters in London, which underlines the well-recognised outstanding importance of the financial centre of London (Taylor et al., 2003; Hall, 2017). The capital city of Scotland, Edinburgh, is the second-largest financial centre in the UK in terms of headquarters with only eight banks, followed by Belfast (five bank headquarters) and Nottingham and Birmingham with three bank headquarters each (Bank of England, 2016). In comparison, only 128 banks (7.1%) of the 1,803 banks in Germany were located in the top financial centre (Frankfurt) in 2015. This is followed by Munich (the second-largest financial centre, with 35 headquarters) and Hamburg (the third-largest financial centre, with 32 headquarters), which have considerably more bank headquarters than their British peers.

[5] Furthermore, cooperation in banking associations allows decentralised banks to operate on economies of scale.

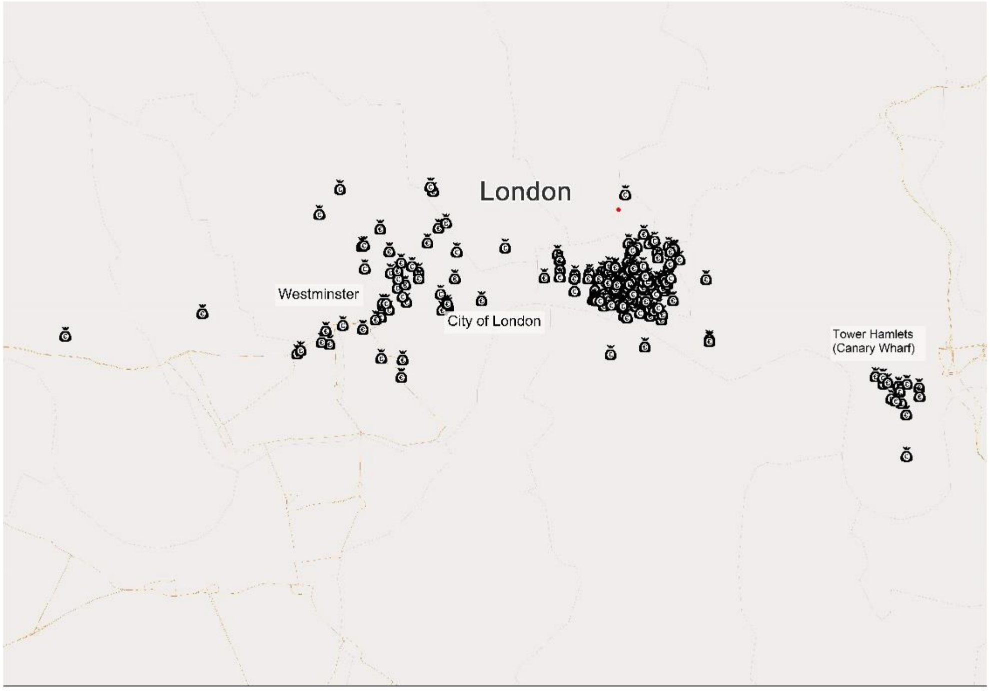
Map 2: Banks' headquarters locations in the UK



Authors' map, source: Bank of England (2017)

The well-known concentration of banking activities in London is clearly visible in Map 3. Most banks are still located in the city of London. Being located in the city of London was important in the past for clearing with the Bank of England (Thrift, 1994). Westminster and Tower Hamlets, i.e. Canary Wharf, are other places where bank headquarters are located. The other 30 boroughs of London hardly show any head-quarters.

Map 3: Banks' headquarters locations in London



Authors' map, source: Bank of England (2017)

Turning to banking associations, due to the non-existence of a public banking pillar and the limited importance of cooperative banks, no pillared banking association system exists in the UK any longer. The British Bankers' Association (BBA) represents its more than 200 bank members, but it represents the banking sector more broadly speaking (BBA, 17 August 2016, interview). In addition to the BBA, there is a range of other trading associations for banks that deal with specific topics of the business like the Council of Mortgage Lenders, Payments UK, the UK Cards Association and the Asset Based Finance Association (for invoice finance and asset-based lending). Only the Building Societies Association (BSA) represents a banking pillar (the building and loan societies and some credit unions). However, the BBA is the general trade association of the banking industry. Accordingly, some MFIs like the Nationwide Building Society and Airdrie Savings Bank are members of both the BSA and the BBA.

The BBA has 70 employees and is located only in London (the BSA also runs its only office in London). The BBA describes its objectives as to rebuild trust in the banking industry. It lobbies the government, e.g. the Treasury, and tries to help its member banks. Therefore, one section of the BBA "deals with the events, they have lots of seminars and events and various things to bring people together and understand information" (BBA, 17 August 2016, interview). At the time of our interview, a project was underway to unify these topic-specific trade associations, as most (larger) banks are members of all the associations anyway (BBA, 17 August 2016, interview).

Overall, this short overview of banking associations makes it clear that several trading associations exist in the UK as they do in Germany. However, in contrast to Germany, these associations do not represent the banking pillars, except for the BSA, but deal with specific topics or areas of the banking business, as a result of which banks are members of most of the banking associations. Accordingly, the banking associations of the UK tend to be less suitable to support decentralised banks in gaining access to knowledge and enabling close cooperation to undertake economies of scale. The fact that member banks of the BBA and the BSA compete unrestrictedly with each other, as no regional market segregation exists in the UK. further hinders intensive cooperation among the (decentralised) banks. The close of Airdrie Savings Bank in 2017, despite the fact that it was a member of the BBA and the BSA, underlines the missing support for decentralised banks. None of the associations were able to support the "exotic" TSB to cope with the increased complexity of banking regulations.

C. Decision-making

Information is the key resource for making lending decisions. Information distribution between savers and borrowers is typically asymmetrical, meaning that borrowers know more about their abilities and willingness to repay than savers (Levine, 1997; Klagge, 2009; Beck et al., 2009; Gärtner 2009, Hartmann-Wendels et al., 2010). The theory of credit rationing states that the asymmetrical distribution of information implies that not all demands for credit can be met. If complete information were available, the interest rate would change accordingly so that each borrower would receive a loan at a rate appropriate to the risk involved. However, banks have reason to exclude riskier groups of borrowers from lending altogether instead of selecting the good-quality borrowers from these groups, because in this way they can lower transaction costs at the price of credit rationing (Stiglitz and Weiss, 1981). This applies in particular to SME loans and start-up finance for which information collection is costly and the average loan volume (and hence, earning opportunity) is low. Distance matters in this context because banks face difficulties in transmitting soft information across distances (Pollard, 2003; Klagge and Martin, 2005; Agarwal and Hauswald, 2007; DeYoung et al., 2008; Alessandrini et al., 2009a, 2010; Canales and Nanda, 2012). For Stein (2002, 1982), "soft information cannot be directly verified by anyone other than the agent who produces it", so its transmission within hierarchical structures or across distances (such as via ICTs) causes difficulties. In contrast, the transmission of hard information is not subject to any restrictions. Actors unambiguously verify hard information such as financial statements, payment history and account information.

According to Alessandrini et al. (2009b), the distance between two actor-pairs matters for bank-based SME lending: firstly, between SME customers and their customer advisors (called operational distance) and, secondly, between customer advisors and supervisors, e.g. head offices (called functional distance). As Flögel (2018) argues, the incorporation of distance in the Stein (2002) model on decentralisation, hierarchy and soft information implies the following relations. Whereas short operational distance eases customer advisors' ability to access soft information, short functional distance is associated with enhanced bank-internal use of soft information, which encourages local staff to actually collect soft information (Flögel, 2018).

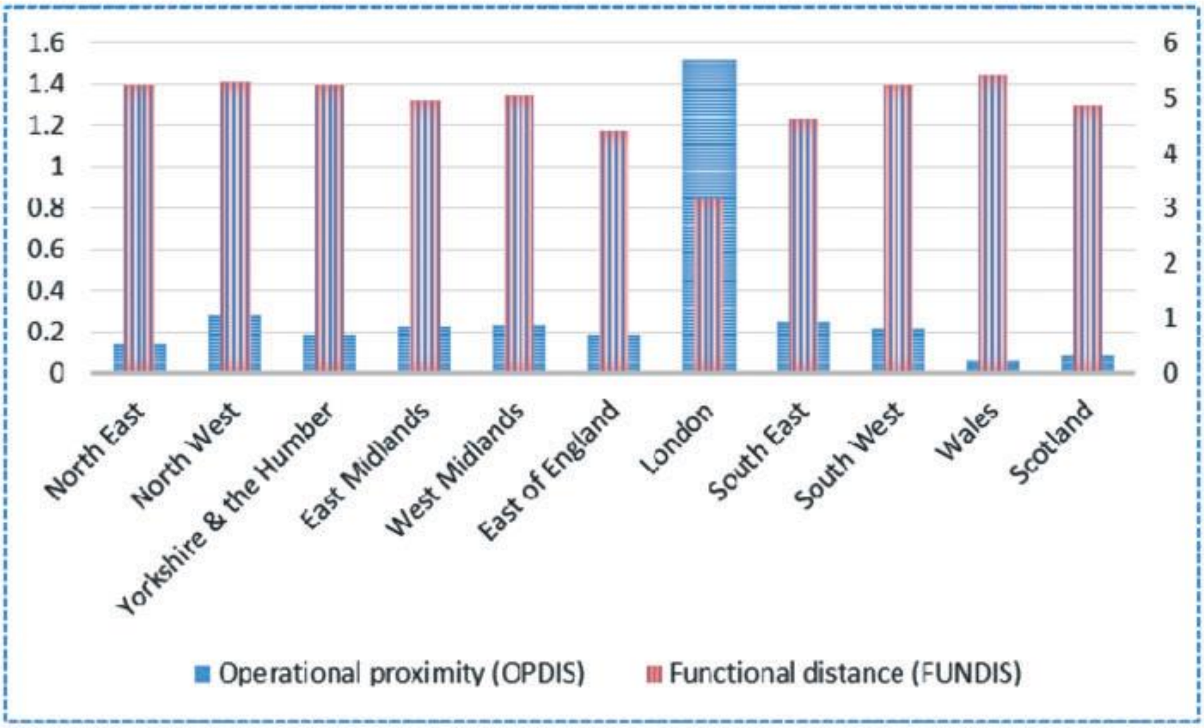
The following section reviews studies about the impact of distance on access to finance in the UK (Section 5). Section 6 reports our qualitative empirical findings of the credit decision-making processes of banks and other financial providers in the UK, classifying them according to their operational and functional distance.

4. Operational and functional distance and access to finance in the UK

A range of studies have shown that SMEs faced difficulties in accessing bank credit in the aftermath of the global financial crisis in the UK (Cowling et al., 2012, 2016; Degryse et al., 2015). A BBA dataset shows substantial variation in SME lending between the postcode areas of the UK's large banks in 2013 (Henry et al., 2014; Degryse et al., 2015). Notwithstanding, this dataset does not provide any information about regional differences in credit demand. Research has therefore focused on spatial differences in the financial constraints faced by SMEs. Using the SME Finance Monitor survey, Lee and Brown (2017) show that innovative firms located in peripheral areas of the UK face higher financial constraints. In other words, their applications for finance are more likely to be rejected.

Zhao and Jones-Evans (2017) apply Alessandrini et al.'s (2009b) approach to functional and operational distance to identify their influence on financial constraints faced by SMEs, controlling for several factors in their regression model, like the riskiness of the SMEs. They compute operational distance by the number of branches per square mile (right-hand axis of Figure 4) of the Nuts 1 regions in Great Britain. Functional distance is calculated by the natural logarithm of the average geographical distance from branches to headquarters weighted by market share (in terms of branches) for each bank in each region (left-hand axis of Figure 4). Unsurprisingly, London shows substantially shorter functional and operational distances than the rest of the country. Using the same survey as Lee and Brown (2017) to compute access to finance, Zhao and Jones-Evans (2017) identify functional distance as one of the reasons for the higher financial constraints found in the periphery, whereas operational distance tends to be unrelated to SMEs' access to credit. SMEs face a 22% higher chance of being financially constrained in Wales (Yorkshire/Humberside 16.3%, East Midlands 13.3%) than in the East of England. Interestingly, the study also identifies the "abnormality of London". London has the most branches per square mile and the shortest functional distance; hence, one would expect excellent access to finance for SMEs there. However, firms in London face 7.6% higher loan constraints than in the East of England, a significant difference to the estimates of Zhao and Jones-Evans (2017). With a similar study design, Degryse et al. (2015) show it is only since the financial crisis that functional distance has led to an increase in the financial constraints of SMEs in the manufacturing sector, whereas this variable was insignificant for the period from 2004 to 2007. This finding suggests a "flight to headquarters" effect for the large banks. Interestingly, the study did not show "flight to quality" effects, meaning a disproportional withdrawal of credit from firms with a higher default risk.

Figure 4: Operational and functional distance in the regions of Great Britain (Nuts 1)



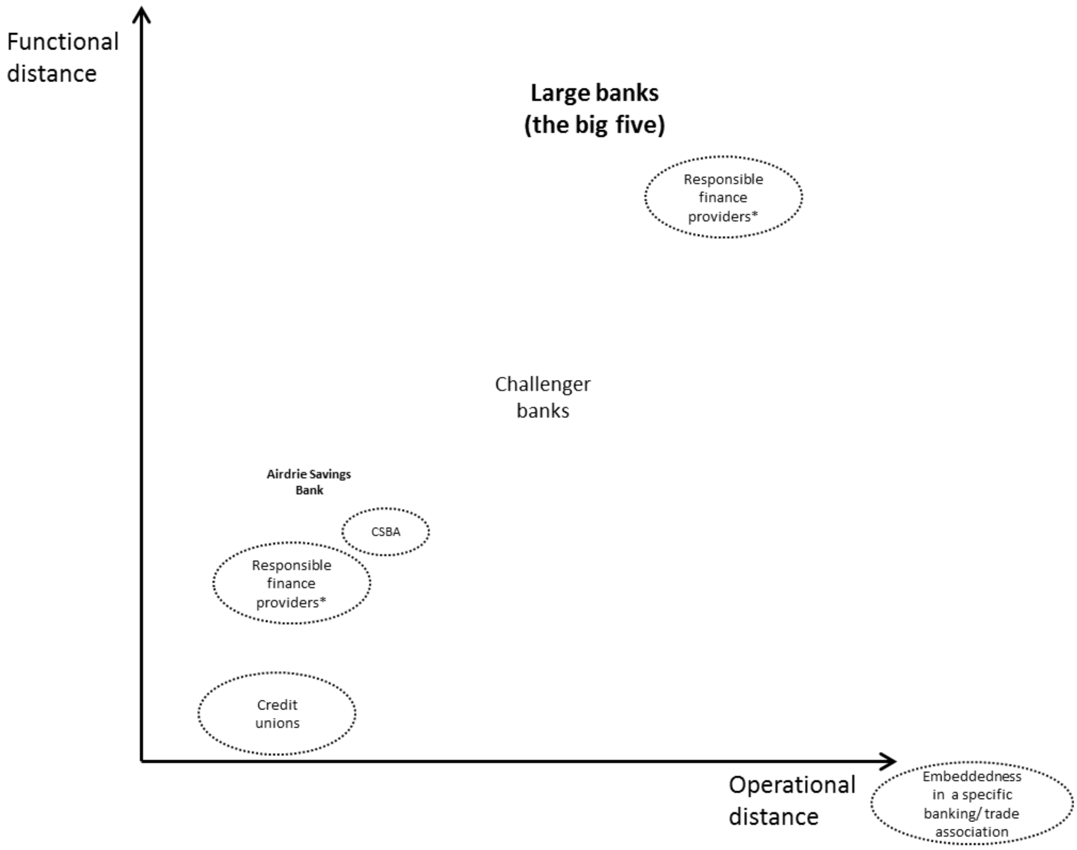
Source: Zhao and Jones-Evans 2017: p. 801

Overall, the studies suggest uneven spatial access to finance in the UK after the financial crisis. In other words, a firm's geographical location has an impact on its ability to gain access to bank credit. Remarkably, however, there is not only less access to finance in peripheral areas, but also in London, which suggests that other effects apart from the metric distance to branches and headquarters influence SMEs' access to bank debt. In this context, a purely metric understanding of distance insufficiently explains information transmission, as short geographical distance is neither a necessary nor a sufficient condition for facilitating knowledge exchange between actors (Boschma, 2005; Torre and Rallet, 2005; Torre, 2008; Bathelt and Henn, 2014). Instead, other dimensions of closeness such as social and organisational embeddedness and cognitive affinity must be considered to fully understand the effect of distance in banking (Uzzi and Lancaster, 2003; Klagge and Martin, 2005; Alessandrini et al., 2009, 2010). Nonetheless, short geographical distance eases the transmission of soft information because it facilitates face-to-face interaction and supports other forms of closeness like social embeddedness. This is one reason why several authors argue that regional banks operating at short geographical distances should conduct superior screening and monitoring of informationally opaque SMEs (Klagge, 1995; Gärtner, 2009b; Alessandrini et al., 2010; Flögel, 2018). We now turn to the geographical and non-geographical aspects of distance in the credit decision-making of banks and other financial providers in the UK.

5. Decision-making process of UK banks and other financial providers

Deviating from the other country reports (Gärtner and Fernandez, 2018; Flögel and Gärtner, 2018), we investigate the place of credit decision-making not only for banks, but also for other finance providers in the UK due to the limited diversity of the banking structure. In particular, credit unions and responsible finance providers are discussed below, in addition to MFIs, meaning the group of large commercial banks (the big five), the challenger banks and the local Airdrie Savings Bank. This section only discusses sources of SME-finance that are based on bank-like financial intermediation. This is not to deny that venture capital, bonds and crowdfunding are relevant sources of funding for UK's SMEs (e.g., Mason, 2010). Nevertheless, in this discussion of the place of decision-making, our country comparison focuses on banks and organisations acting like banks. Figure 5 displays the functional and operational distance of the studied banks and the other financial providers. The position of the studied organisations in the x- and y-axis are heuristically estimated and not calculated. The font size of their names indicates the lending volume to business to give an impression of the comparative importance of the banks. Finally, encircled bank names indicate that they are embedded in a specific banking association. As discussed in Section 3, no pillared bank association exists for MFIs, hence embeddedness only applies for the other financial providers, meaning credit unions and responsible finance providers that have specific trade associations.

Figure 5: A heuristic classification of distance in SME finance of banks and other financial providers of the UK (font size illustrates the volume of business loans)



*Depending on the scheme, responsible finance providers tend to approve loans at rather short or rather long functional and operational distance.

Source: Authors' figure

Large banks (the big five)

Unfortunately, it was not possible to conduct interviews with bank employees from one of the five large commercial banks (HSBC, RBSG, LBG, Barclays and the Santander Group) during our time conducting research in the UK. Thus, the following report relies on existing scientific studies and statements by the interviewed experts (regional bankers and other financial providers, banking associations, think tanks and academic experts).

The interview partners outlined a major change in business lending by the large commercial banks approximately in the mid-1990s. The old system was characterised by close relationships between clients and local managers (customer advisors) in the branches. The local customer advisors enjoyed considerable lending autonomy and approved credit on the basis of trust and local knowledge. In contrast, today local customer advisors sell loans and other services on the basis of predefined criteria, such as credit scores, and have very limited discretion (RSA, 16 August, interview; CSBA, 12 September, interview; academic expert, 18 August, interview; BBA, 17 August, interview; RFA, 1 September, telephone interview; academic expert, 13 September 2016, interview). This lack of local lending authority among the large commercial banks is criticised because central lending limits fail to take specific local circumstances into consideration, for example (RSA, 16 August, interview), and make it harder to take local and soft information into account. On the other hand, the BBA also points out that the old system was rather conservative and prone to error, arbitrariness and discrimination (BBA, 17 August, interview). For example, customer advisors had few incentives to lend. Furthermore, lending was based on trust and personal relationships rather than objective criteria, which caused poor lending decisions. The general curtailing of lending authority from local branches and their managers is also well documented in the literature (Leyshon and Thrift, 1999; Leyshon and Pollard, 2000; Mason, 2010; Vik, 2016). Below we will look into the details.

Starting with **operational distance**, the long term and continuing trend of branch closures among the large banks is well documented in the UK (French et al., 2008; Prestridge, 2017). Altogether, the big five banks[6] still had approximately 6,600 branches in 2017 (*The Daily Telegraph,* 2017), although precise figures are unavailable. Turning to non-geographical aspects of operational distance, according to the interviewed experts, larger SME-clients (with a turnover of over £1 or 2 million) tend to have a designated local customer advisor, meaning a customer relationship manager, whilst smaller SMEs have no fixed personal advisor and rely instead on alternative service channels like online applications and call centres (BBA, 17 August, interview; Löher and Schröder (2018) report similar statements from interviews). In reaction to the new challenger banks, especially Handelsbanken, the large banks have put more effort into personal relationship managers. As such, "what is often said is that the big four banks have now decided that they want to copy Handelsbanken" (RSA, 16 August, interview). Accordingly, operational distance in terms of embeddedness depends on the size of the SME, as only larger firms have designated personal customer relationship managers.

Concerning **functional distance,** the expert from the Royal Society of the Arts (RSA), an organisation that has lobbied for the common good since 1754, voiced his frustration with centralisation trends in the UK:

> "All regional anything in this country is being merged to bigger and bigger institutions. And I think there is still this general bias that it is dangerous to give too much power to have local standalone institutions" (RSA, 16 August, interview).

The interview partners consistently described the authority of the large banks' local customer advisors, meaning local decision-making, as limited (RSA, 16 August, interview; CSBA, 12 September, interview; academic expert, 18 August, interview; BBA, 17 August, interview; RFP, 12 September, interview). Banks set lending criteria centrally for the whole country, which can hinder appropriate lending from the perspective of local circumstances:

[6] Due to M&A, the large banking groups run various retail brands.

> "The credit criteria have been set globally. It doesn't take into account the circumstances […] so, that's one of the dangers that this setting of a probably quite sensible analysis of this global or national level has: it doesn't take into account any of those [local] circumstances. […] The amount of the loan which local managers can take a decision over is now small, I don't know exactly what it is. Now, in recent years, all of the main four UK banks have said that they have put more money back into the relationship managers and more relationship managers in branches. But, when I have had an opportunity to ask this question it seems they might have more relationship managers who are based in branches, but they still don't have the lending decision. So, their job is to look after the relationship, but, you know […] they might be actually gathering some soft information, keeping the customer happy that they have got someone they can talk to" (RSA, 16 August 2016, interview).

Due to the limited authority of local customer advisors, their job is a "no-brainer", since they may come to a lending decision based on the hard and soft information they gather about a given customer relationship but cannot use the information because the headquarters, or central lending criteria or credit scores, determine lending. This is why the old generation of customer advisors have left the large banks (often by retiring) and the new generation is trained to sell products. Therefore, the interview partner from the RSA is sceptical about possible attempts to delegate more authority to local customer advisors as he fears the soft screening standards of the new generation of customer advisors.

Studies on discretion in lending decisions depict a more nuanced picture of the large banks in the UK (Wilson et al., 2007; Deakins et al., 2010; Wilson, 2015). On the basis of a large-scale qualitative study on one large bank in the UK from 2003 (primarily searching for discrimination against female business owners) (academic expert, 8 September, interview), Wilson (2015) reports how lending processes differ depending on the amount of credit. The bank applied a simple score for credit up to £100,000, in which local customer advisors had to add the necessary (basic) information. For larger credit requests made by SMEs, the customer advisors had to compile a credit application where they explained the credit request and their lending decision. The customer advisors usually conducted face-to-face interviews with the SMEs applying, collect a large set of information and conducted their lending decision by making use of personal judgment and their "gut feeling". The credit application was sent to a credit committee or credit sanctioner who conducted the final lending decision. In both cases, the scoring process and the credit committee or credit sanctioner process, the local customer advisors reserved the initial right to reject, meaning they decided whether they want to lend in the first place, which represented a potential source of gender discrimination in Wilson's (2015) findings. In Germany, the customer advisors of savings banks and large banks also have the right of initial rejection and Wilson's description of the lending process organisation tends to be comparable to the process organisation of the large commercial banks in Germany (Flögel, 2018).

Using data from 2008, Deakins et al. (2010) analysed SME lending by several major banks in Scotland. They compiled five cases of credit applications by real firms and asked the customer advisors of different banks in qualitative interviews how their banks would decide in these cases. Deakins et al. (2010) report that the local customer advisors have some discretion in credit decision-making, so the sector as well as the geographical location influences credit decisions, meaning that greater operational distance negatively impacts the likelihood of a credit being approved. The sector matters because large banks tend to discriminate against selected sectors (by reducing new lending) that are perceived to have a poor outlook from a global perspective. Furthermore, according to Deakins et al. (2010), customer advisors devote more effort to granting additional credit to existing clients than to new customers. In this context, customer advisors possess the most discretion in granting medium-sized loans because banks decide on small credit (around £50,000) using standardised credit scores, so the customer advisors have limited influence over the results. On the other hand, the supervisors at the headquarters decide on large credit, so customer advisors also have limited means to influence this type of lending. Nevertheless, Löher and Schröder (2018) report that banks have increased centralisation and standardisation in SME lending in response to new banking regulations enacted by the UK government (aimed at increasing competition in SME lending) since the financial crisis. The studies of Wilson (2015) and Deakins et al. (2010) do not consider these new changes.

Overall, the studies and interview results indicate that large commercial banks in the UK tend to operate from a medium operational distance and long functional distance (Figure 4, p. 22). However, functional distance differs between firms depending on the characteristics of the firms applying and the credit amount, a result we have also found for large banks and to a lesser extent for the savings banks in Germany (Flögel, 2018; Flögel 2018b; Flögel and Gärtner, 2018). Whereas the functional distance of the UK's large commercial banks might be comparable with that of large banks in Germany, the operational distance tends to be shorter in non-geographical terms in Germany, as rather small SMEs also have personal customer relationship managers there (Flögel and Gärtner, 2018; Flögel, 2018).

Challenger banks and Airdrie Savings Bank

The interviewees mentioned challenger banks as an alternative to large banks for financing SMEs (RSA, 16 August, interview; BBA, 17 August, interview; Airdrie Savings Bank, 7 September, interview; CSBA, 12 September, interview) and because they tend to operate on a more decentralised (short-distance) business model than the big five. Challenger banks differ in terms of ownership, business model and regional market orientation. Short distances in lending are partly explained by the smaller size of the newer banks, e.g., Aldermore was founded in 2009 and Cambridge & Counties Bank was founded in 2012. Furthermore, challenger banks tend to strive for *Hausbank* relationships with SMEs. In particular, the UK subsidiary of the Swedish Handelsbanken was mentioned as a good example of a decentralised bank (RSA, 16 August, interview; BBA, 17 August, interview), even though it is "only" a branch of a foreign bank.

Exemplarily for the challenger banks, the Swedish Handelsbanken is discussed: as of 2017, **Handelsbanken** ran 207 branches in the UK and lent £11.4 billion to firms. Handelsbanken's business model is so successful that they are continuously opening new branches at a time when competitors are actually closing subsidiaries (Martin, 2017). According to Kroner's (2009) portrayal of Handelsbanken, the success of the business model lies in its decentralised organisation, together with its prudence or risk aversion and a slow-growth strategy. "'The branch is the bank' is the summary of Handelsbanken's strategy" (Kroner, 2009). The branch managers wield substantial decision-making authority, not only with respect to lending, but also concerning pricing, marketing, customer segmentation (that is, the question of how to serve customers) and back-office work. Interestingly, Handelsbanken conducts regional market segmentation (every branch has its designated market area and lending outside the area is not permitted) and even supports regional savings-investment cycles. Branches are rewarded for equalising their (virtual) balance sheet, meaning that they match savings with lending in terms of maturities. Nevertheless, of course, the bank's internal capital flows help to close local funding gaps.

Turning to functional distance, Handelsbanken gives local branch managers considerable authority (local staff members always have the initial right to reject regardless of the size of the loan application), but closely monitors performance. According to Kroner (2009), this is motivated by the consideration that local branches possess the most information on clients and local markets, which enhances lending decisions (for example, by considering soft information and the local knowledge of local managers). Non-performing loans are dealt with in the branches (and not processed in a separate department like in most large banks), so customer advisors remain responsible for their lending decisions and their careers rely heavily on the performance of their loan portfolio. Of course, local branches do not wield unlimited authority. Different hierarchical levels become involved in the lending decision depending on the size of the loan (and on the experience of the branch manager). The hierarchical level following the branch is the so-called regional bank. All branches belong to one of the two regional banks in the UK. The regional bank level monitors and coaches its branches and their managers. About 3-4% of Handelsbanken's loan applications need approval at the CEO level in Stockholm. This is a low percentage in the industry according to Kroner (2009). Remarkably, Handelsbanken does not operate under any individual incentives (variable income) either. Instead, employees' long-term success is rewarded with career opportunities. Overall, Handelsbanken can be considered a rather decentralised bank. Nonetheless, we classified Handelsbanken and all challenger banks as having a mid-level operational and functional distance (Figure 5, p. 20) because they tend to show greater operational and functional distances than the "real" regional savings and cooperative banks in Germany.

Having said this, it should be noted that the ability of Handelsbanken and the other challenger banks to improve SME finance in the UK is somewhat limited, because they tend to target rather larger and wealthier SMEs that are not as risky. These clients are more profitable than the mass market of moderate SMEs and especially small and micro businesses (CSBA, 12 September, interview; RFA, 1 September, telephone interview). As argued by Flögel (2018), smaller SMEs and firms in financial distress tend to gain the most from lending across short distances, as in these cases soft information can really make a difference in lending decisions.

Other than Handelsbanken, **Airdrie Savings Bank** targeted smaller business clients in 2016. The TSB did not restrict its market area, but had business clients in central Scotland, though most clients were located near the town of Airdrie. A team of 12 credit officers were in charge of business lending and clients had no fixed credit officer. However, the bank was so small that all clients usually knew all credit officers and vice versa. Likewise, there was no division between the front and back offices: the credit officer team served the clients and conducted the back-office work. The credit officers had limited lending authority. Instead, a credit sanctioning committee (in which the CEOs and others participated) decided on larger credit applications. The credit officers in charge did not participate in the committee meetings. To ensure timely lending decisions, the sanctioning committee met at-hoc on demand and credit officers discussed lending decisions in advance with the CEO, because it was a small bank with close relationships between staff and CEO. A rating system was not applied. Rather, the bank conducted risk analysis by hand (for example, risk classification was conducted by the degree of collateralisation of loans). Due to the small size of Airdrie Savings Bank, lending was restricted to smaller credit volumes (£2 or 3 million would have been too much). Surprisingly, the bank also applied rather pronounced sector restrictions. For example, it prohibited lending to the renewable energy sector and pubs, which the CEO explained by a lack of knowledge (in the case of the former) and bad experience in the past (for pubs) (Airdrie Savings Bank, 7 September, interview). Overall, Airdrie Savings Bank is classified as a short-distance bank in terms of functional and operational distance, especially because of its small size and the resulting short (functional) distance between credit officers and decision makers.

Non-bank lenders

"**Credit unions** were traditionally just savings and loans. So you joined and became a member and then, if you wanted a loan you would have to save traditionally for six weeks or so, and then you could get a loan double to what was in your savings" (academic expert, 7 September, interview). Membership in a credit union was a long-term relationship and becoming a member was a restricted and long-lasting process that entailed personal meetings and so on. Credit unions replace pawnbrokers, payday lenders and commercial banks by serving their lower income members and are generally more client-oriented lenders (for example, by avoiding hidden fees). In this respect, the interest rates of credit unions are rather high, ranging up to 3% per month, as they only gain money from short-term lending. Today, some credit unions are tending to develop the lending approach of a more "ordinary bank", for example by making it possible to gain instant membership and even loans, whereas other credit unions remain governed by the traditional lending model (academic expert, 7 September, interview). Overall, the traditional lending model of credit unions tends to be very local and community-based, with very short operational and functional distances in terms of screening and monitoring (ensuring repayments). With the relaxation of common bond requirements, distance in lending is likely to increase. Nevertheless, no information about the new segment of business loans was gained in the interviews. Here credit unions still tend to be very new lenders.

The **RFP** interviewed is actually a group of companies and provides not only funding, but also business advice and training, similarly to many other RFPs. Its geographical reach in lending depends on the scheme and company in question; some schemes have a local focus, whereas under other schemes companies lend across the whole of England (RFP, 12 September, interview). Lending decisions in the business growth loan scheme and the start-up loan scheme are presented as examples below, as they differ substantially in terms of distance in the credit-granting process and make up the bulk of the lending conducted by this RFP.

The business growth loan scheme targets existing businesses that need capital to invest in growth. Lending of up to £150,000 is permitted. Four business advisors from the RFP conduct the screening and monitoring. They receive the initial contact, usually by e-mail or telephone, and help the business owners to put together the application. The business advisors check the applications and if they seem promising, they invite the applicants to a personal meeting where open questions are discussed and additional documents are requested. If positively impressed, advisors forward the application for approval. The CEO of the RFP approves loans of up to £10,000. All other requests go to an external committee, meaning a local panel of stakeholders including local bankers and business organisations where the applicants submit their proposals in person. According to the interviewed CEO, the committee meetings work somewhat like *Dragons' Den* (the British reality TV-show where start-ups bid for VC investment), since the business owners have to convince the committee to grant them the business growth loan (RFP, 12 September, interview). Each business advisor is responsible for his or her credit applications and often also advises the clients after they receive the loan. The RFP monitors loan repayment with an automatic ICT-system that informs business advisors if one of his or her clients delays repayments. The RFP gives growth loans only to comparatively less risky proposals because it has to carry a significant share of the default risk. This share will tend to increase after the end of the government's regional growth fund because the growth fund currently provides part of the funding and secures a proportion of the losses in case of default.

Compared with the business growth loan scheme, the start-up loan scheme involves much less personal interaction. The scheme is sponsored by the UK government and targets riskier individuals who can receive a loan of up to £25,000 in order to start their business (most loans are much smaller than £25,000). RFPs do not take responsibility for loan defaults and receive a commission for every loan granted. In 2016, the scheme changed the screening process and introduced centralised credit scoring in order to reduce the high default rate of start-ups loans. The scoring focuses on the solvency of the founder and RFPs are only allowed to lend if the scoring permits it, meaning that they hardly exercise any discretion in the lending decision. Therefore, lending in the start-up loan scheme has changed substantially with the introduction of the scoring systems (RFP, 12 September, interview). The RFP reported that some loans that would have been approved before the scoring system was introduced are now rejected, whereas other loans that would have been rejected in the past are now approved by the scoring system. In these cases, the RFP nonetheless grants the loans, as he or she does not bear the default risk. In terms of distance, the RFPs approve growth loan applications from founders all across England. The approval process is conducted via e-mail, Skype and telephone; face-to-face meetings are the exception, not the rule. Considering this lending process, we classified the lending of RFPs under the start-up loan scheme as rather long in terms of operational (no personal meetings) and functional distance (a simple score decides, and RFPs have no discretion). Considering the fact that the RFP interviewed approves a large share of loans under the start-up loan scheme (RFP, 12 September, interview) we split the classification of RFPs in Figure 5 (p. 20). Lending under schemes like the business growth loan tends to be short in terms of operational and functional distance, whereas the start-up loan scheme suggests the incorporation of long distance in the lending process organisation because a scoring system decides at the end of the day.

Overall, the heuristic classification developed in this section illustrates the lack of important short-distance finance providers in the UK (see Figure 5, p. 20), symbolically underscored by the closing of the last local savings bank in 2017. Credit unions and RFPs (depending on the scheme) can be considered short-distance lenders. However, in terms of credit volume, they lend much less than £500 million to business in total. Challenger banks seem to lend at shorter distances than the big five commercial banks and have increased lending significantly, especially to SMEs. Still, they tend to target larger and more affluent SMEs. Given these general observations, it is not surprising that several organisations are attempting to re-establish regional banks.

D. Regional banks for the UK?

In light of the lack of short-distance banks, it is unsurprising that a range of initiatives have called for the (re)establishment of regional banks in the UK (*The Economist,* 2012; Greenham and Prieg, 2015; Community Savings Banks Association, 2016). The decentralised German banking system tends to be a role model in this context. Thus, following the example of the German savings and cooperative banking groups, such calls demand dual bottom-line regional banks for the UK that should form a banking group supported by a strong banking association (for example, see Greenham and Prieg, 2015). Three different ways to (re)create regional banks have been identified.

The New Economic Foundation, together with two other think tanks (Civitas and ResPublica), published a seemingly smart approach that would create a regional and public banking group with a substantial market share in one stroke (Greenham and Prieg, 2015). In essence, the proposal calls for the restructuring of the RBSG into a network of local banks with a public service mandate. This proposal is feasible due to the government's majority ownership of the RBSG since its bailout in the financial crisis. According to Greenham and Prieg's (2015) analysis, the RBSG could be split into 130 local banks in England, which would cooperate in one financial group. Furthermore, the business of the new regional banks should be focused on retail banking (implying that the RBSG investment business should be sold) and each of the local banks should be controlled by local stakeholders. We interviewed one of the authors of the proposal, who explained that as far as he knows it would not currently work because the RBSG has an outdated ICT system that would make segregating the customer database almost impossible (RSA, 16 August, interview). Hence, at the time of the interviews in August and September 2016, it seemed unlikely that the proposal would take shape. Moreover, the government had started gradually selling off small pieces of the RBSG.

The second suggestion is to re-create regional banks entirely from scratch with the help of a new association that would provide economies of scale and knowledge in order to enable local people to create their local banks. Two organisations, Local First (http://local-first.org.uk) and the Community Savings Bank Association (CSBA; www.csba.co.uk), are trying to push for a new group of regional banks of this sort independently of each another. We interviewed a key person from the CSBA (CSBA, 12 September, interview) and outline the CSBA's idea below.

At the time of the interviews, the CSBA was in the process of creating a "bank in a box", which means a regional bank concept ready for local application. The "bank in a box" includes a bank licence, ICTs (including the integration of ATMs), lending process organisation, legal form, market intelligence, etc. (CSBA, 12 September, interview). For the creation of the "bank in a box", the CSBA literally copied Airdrie Savings Bank in that they used the documents of Airdrie's existing bank licence (around 1,000 pages long) for community savings banks' (CSBs) licensing processes with UK bank supervision. Unlike Airdrie Savings Bank, however, the CSBs should be founded as cooperative banks that are only allowed to conduct business with their members. The cooperative banking model helps to gain the necessary equity capital for lending and entails tax advantages. Following the example of the Handelsbanken lending process organisation, CSBs should grant substantial authority to the local branches. Here, two individuals should be involved in the lending decisions to SMEs: the customer advisor (who is usually the head of the branch because SME clients are under his or her responsibility) and the credit officer, who is also located in the local branch. Credit officers' performance should be compensated in line with the default rates of their credit portfolios. Only very large credit engagements should need approval from high-level supervisors outside the branch. The CSBA plans to buy an external rating system for risk classification, one that includes behavioural characteristics of the customers in the credit score. Also, to gain sufficient information about the customers, CSBs should try to build *Hausbank* relationships with clients, which includes keeping their current accounts. Unlike Handelsbanken, CSBs should be more retail-oriented, targeting smaller clients with modern ICTs and simple products. Here, the interview partner also saw an economic advantage over Airdrie Savings Bank, as substantial earnings should come from payment transactions and other retail services in order to reduce dependency on interest surplus (CSBA, 12 September, interview).

A third way to establish local banking in the UK involves the upscaling of credit unions and responsible finance providers. Interestingly, each of these finance providers already has a specific trade association, lobbying in the interest of its members. Here, credit unions may be closer to regional banks because accepting customers' savings makes them less reliant on government money (though credit unions also receive financial support from the government). Learning from the historical experience of the TSBs as well as building and loan societies in the UK and Spanish savings banks (Gärtner and Fernandez, 2018), we would advise the introduction (maintenance) of a regional principle, meaning regional market segregation. A regional principle reduces the decline in the number of institutions, limits competition within the financial groups (thereby allowing a strong association to be formed) and enables lending decisions at shorter distances to clients, which is associated with better access to soft and local information and, therefore, less risky lending.

Overall, all three attempts to (re)establish regional banks in the UK are promising, although despite being attractive, the RBSG proposal seemed less realistic at the time of our interviews. Nevertheless, the current low interest rate environment and increased complexity in banking regulations (both resulting from actions that were taken to tackle the financial and economic crisis) make running regional banks challenging (for Germany, see Gärtner and Flögel, 2017), as underlined by the closure of the last savings bank in the UK. If it is in the public interest to have a decentralised banking system with regional banks, it may be appropriate to find means to support regional banks.

Acknowledgements

We would like to acknowledge the financial support of the Hans Böckler Foundation and thank all the participants in the empirical study, as well as the advisory board of the project for their valuable comments on an earlier version of this article. Let us also acknowledge the excellent language support provided by Dustin Langan, Katharine Thomas and Sarah Wittig.

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List of interview partners

Academic expert, 13 September 2016, interview: Newcastle University

Academic expert, 3 August, interview: University of Glasgow

RSA, 16 August, interview: Royal Society of Arts

Academic expert, 17 August, interview: London School of Economics and Political Science

BBA, 17 August, interview: British Bankers Association

Academic expert, 18 August, interview: Lancaster University

RFA, 1 September, telephone interview: Responsible Finance Association

Airdrie savings bank, 7 September, interview: Airdrie Savings Bank

Academic expert, 7 September, interview: University of Glasgow

Academic expert, 8 September, interview: University of Glasgow

CSBA, 12 September, interview: Community Savings Bank Association

RFP, 12 September, interview: Responsible Finance Provider

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ISSN electronic edition: 2511-7254

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Zentrale wissenschaftliche Einrichtung der Westfälischen Hochschule in Kooperation mit der Ruhr-Universität Bochum

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