Regions, cities and finance: The role of capital shocks and banking reforms in shaping the UK geography of prosperity

Authors:
Michiel Daams[x]
University of Groningen
Colin Mayer
University of Oxford
Philip McCann[y]
The Productivity Institute

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[x] The Productivity Institute
[y] The University of Manchester

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Authors' contacts
philip.mccann@manchester.ac.uk

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Abstract

This paper examines the role played by financial markets, and in particular, changes in the price and access to capital, in shaping UK regional growth fortunes. We use uniquely detailed real estate investment data to generate risk-pricing indices for all UK regions and cities over a twenty-one-year period. This demonstrates that, since the 2008 global financial crisis, global financial markets underwent a profound regime shift which partitioned the UK into fundamentally different capital market pricing regimes.

City centres in second-tier and third-tier cities have borne the brunt of adverse capital shocks, and this partitioning provides a demand-side explanation as to why economic growth in the UK's non-core regions outside of London and its immediate hinterland has so seriously struggled in recent years. Rejuvenating the growth trajectories of these cities therefore also requires fundamental reforms to the UK banking and financial system towards a more decentralised system.

A more decentralised and localised UK banking and financial system is essential for regenerating city business ecosystems. However, the modern history of the UK banking system has been dominated by movements away from primarily local financial ecosystems, to a highly centralised, top-down and London-centric system. Therefore, finding ways to reverse these trends is essential in order to foster the rejuvenation of the commercial centres of second-tier and third-tier cities.

Introduction

This paper examines the role played by financial markets, and in particular, changes in the price and access to capital, in shaping UK regional growth fortunes. We use uniquely detailed real estate investment data to generate risk-pricing indices for all UK regions and cities over a twenty-one year period.

This demonstrates that since the 2008 global financial crisis, global financial markets underwent a profound regime shift which partitioned the UK into fundamentally different capital market pricing regimes. City centres in second-tier and third-tier cities have borne the brunt of adverse capital shocks, and this partitioning provides a demand-side explanation as to why economic growth in the UK's non-core regions outside of London and its immediate hinterland has so seriously struggled in recent years. Rejuvenating the growth trajectories of these cities therefore also requires fundamental reforms to the UK banking and financial system towards a more decentralised system.

In order to explain these issues, the rest of the paper is organised as follows. The next section discusses in detail the nature and scale of the UK regional capital shocks and the resulting current financial risk-pricing landscape of the UK regions and cities. The findings of this section demonstrate that since the 2008 global financial crisis, the UK has been partitioned into two entirely different financial regimes, namely London versus the rest of the UK regions. Moreover, the places which face the most adversely capital pricing regimes are the city centres in the UK's second-tier and third-tier cities.

The third part of the paper, which is broken up into four sub-sections, then explains how this situation has arisen. It does this first by discussing the evolution of the UK banking system away from one of primarily local financial ecosystems, to a highly centralised, top-down and London-centric system. The section then discusses potential reforms to the UK banking and financial system which are necessary in order to begin to foster the rejuvenation of the commercial centres of second-tier and third-tier cities. In particular, finding ways to rebuild a more decentralised and localised UK banking and financial system is essential for regenerating city business ecosystems. The fourth section provides some brief conclusions.

The Regional and Urban Features of UK Risk Pricing

It is nowadays widely accepted that the UK displays very high interregional and inter-urban productivity and prosperity inequalities by OECD standards (McCann 2016, 2020; Carrascal-Incera et al. 2020; Davenport and Zaranko 2020; Raikes et al. 2019; Allen 2024), and that the reasons for this concern a complex mixture of geographical structure, the differential impacts of globalisation and increasing governance centralisation (McCann 2016). Most second-tier and third-tier UK cities have central business districts which are very small in comparison to OECD comparator cities (Swinney and Enenkel 2020; Breach and Swinney 2024), and display no real agglomeration economies of scale or density (McCann and Yuan 2022). As a result, large UK urbanised regions typically underperform economically relative to what is observed and expected on the basis of international comparisons (Arbabi et al. 2019, 2020). Meanwhile, London and its immediate hinterland has been decoupling from the rest of the UK on multiple economic dimensions for the last four decades (McCann 2016). As such, the UK today has been characterised as a "hub, no spokes" (Haldane 2018) economy.

Explanations for these regional differences are typically sought in terms of supply-side issues, and in particular, the current differential regional skills and educational attainment profiles are often seen as a primary cause. However, the UK's regional productivity differences emerged well before the current regional gaps in skills and educational attainment appeared (McCann 2016) and UK interregional mobility has barely changed in four decades (McCann 2024). Moreover, today's UK interregional differences across both educational levels and unemployment rates are small by OECD-wide standards (OECD 2018), and relatively far smaller than the regional productivity differences. These observations all suggest that other demand-side explanations must also be sought to account for the persistent regional productivity inequalities.

Clues to this arise from the fact that one of the most extreme features of these regional inequalities is manifested in terms of high regional variations in many forms of access to both public (McCann 2023) and private capital and investment finance (Mayer et al. 2021). Most strikingly, some three-quarters of angel investments and venture capital are concentrated within London and its hinterland (McCann 2023; 2024a and Mayer 2024b), and this concentration has actually been growing in recent years (Mayer et al. 2021; McCann 2024). Yet, the apparent lack of access to growth capital in non-core regions is prima facie rather puzzling. In a highly deregulated economy such as the UK, with good regulatory frameworks and with some of the deepest capital markets in the world, capital market risk-pricing and the resulting interregional capital allocations ought to seek out higher growth opportunities in lower costs regions thereby fostering a more even distribution of investment and contributing to the rejuvenation of economically weaker regions. These capital flows should therefore drive interregional convergence processes. Yet, this is not what we observe in the UK, and this has previously represented something of a puzzle (Mayer 2024a and Mayer 2024b; Mayer et al. 2021).

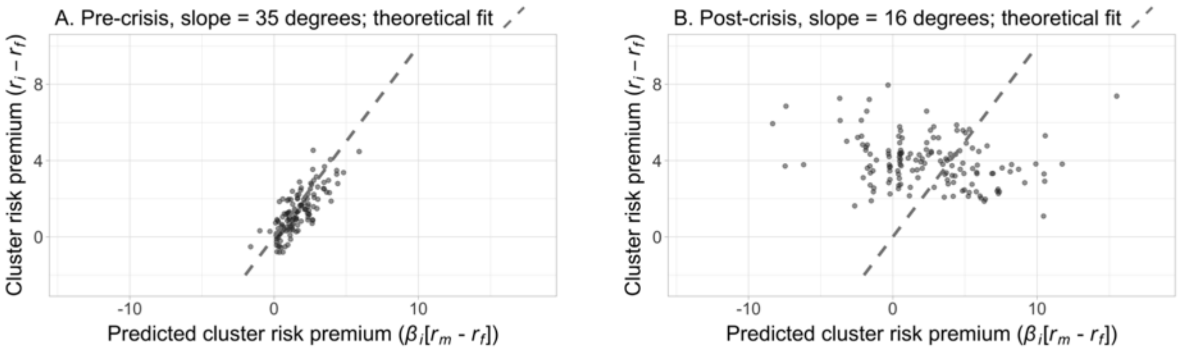
However, there is now a growing body of evidence (Daams et al. 2024a,b, 2025) emerging from The Productivity Institute[1] that a fundamental reason why many UK regions do not enjoy significant inward capital flows is due to the profound capital market shocks wrought by the 2008 Global Financial Crisis. New research (Daams et al. 2024a,b) based on large-scale commercial real estate investment transactions[2], allows us to compute Ben Bernanke's 'External Finance Premium' (Bernanke 2022), which is the difference between the perceived risks priced-in by capital market investors and the official yields on sovereign bonds and central bank discount rates. The techniques by which we are able to do this are discussed in detail elsewhere (Daams et al. 2023, 2024a,b). However, for our purposes, what is important is that our data allows us to directly observe the individual investment yields and to calculate the Capital Asset Pricing Model CAPM risk-premia. On the basis of 12,681 investment transactions in the secondary market, we are able to calculate the average yields, risk-premia, and the dispersion properties in these yields and risk-premia, for every UK region and city over a twenty-one year period 2003-2023.

What our research demonstrates is that prior to the 2008 crisis, as we see in Figure 1A., investors were able to effectively price-in risk across UK cities and regions and the observed risk-premia and investment yields both broadly followed textbook frameworks. However, as we also see in Figure 1B., the onset of the 2008 crisis brought about a profound capital market regime change from an environment of risk to one of radical uncertainty (Kay and King 2020), whereby investors were no longer able to effectively price-in investments (Daams et al. 2024a). This radical uncertainty engendered a rapid capital flight-to-safety in the UK (Daams et al. 2024a), the USA (Daams et al. 2024b) and the rest of Europe (Daams et al. 2025), and this

[1] https://www.productivity.ac.uk
[2] The datasets are built by RCA-MSCI and the details are provided in Daams et al. (2023, 2024a,b).

flight-to-safety involved surges of capital inflows into clusters and central business districts within key 'safe haven' cities at the expense of other places.

Figure 1. Pre-Crisis and Post-Crisis CAPM Relationships in Commercial Centres

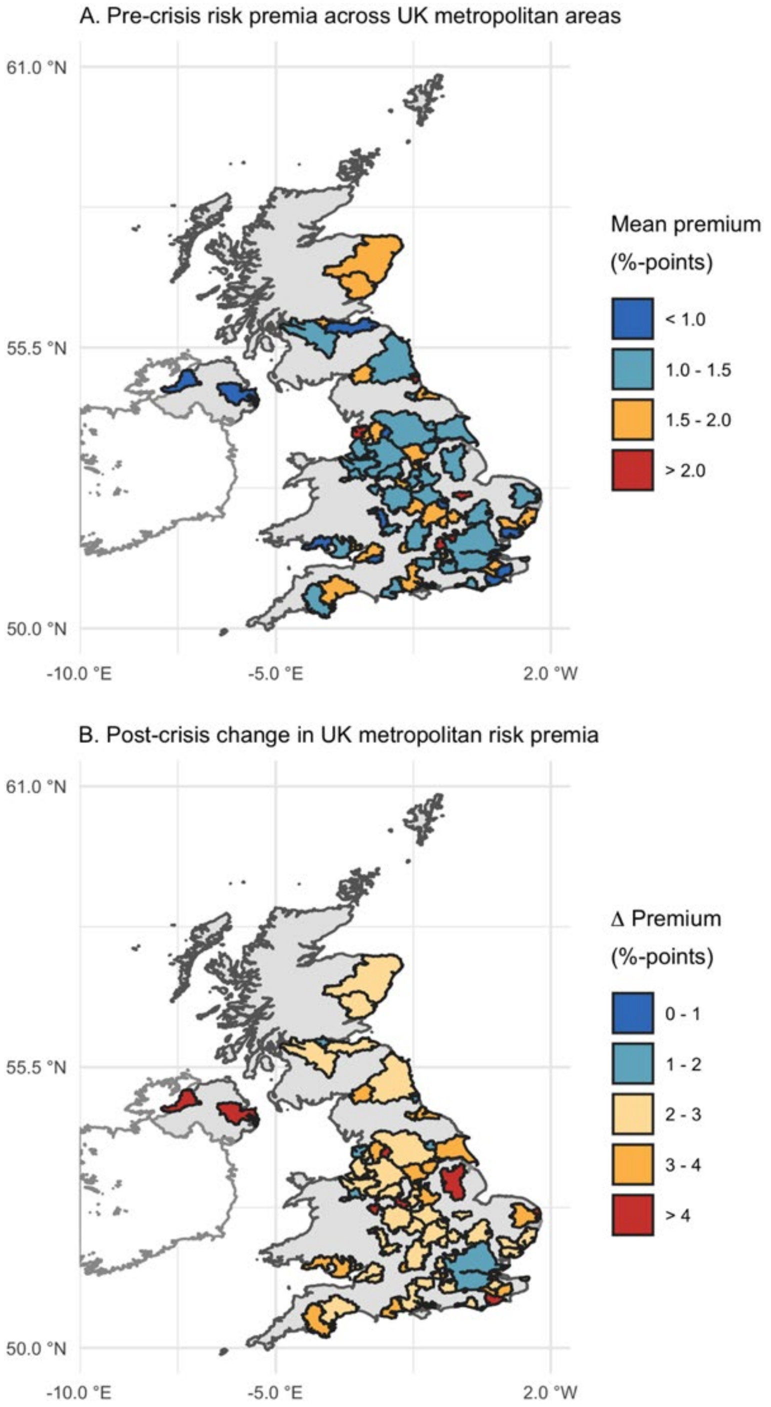


Source: Daams et al. (2024a)

In the aftermath of the 2008 crisis, these 'safe havens' cities and regions enjoyed burgeoning inflows with capital priced at record low rates while other regions experienced rapid capital outflows, with any remaining capital priced at exorbitant rates. In addition, real estate equity is the most important form of entrepreneurial start-up and scale-up collateral, and in safe havens, the local real estate owners enjoyed soaring collateral leveraging positions whereas is other regions, the collateral leveraging positions deteriorated dramatically (Daams et al. 2024a,b). The long-run impacts of these capital shocks are that regions which enjoyed capital inflows experienced higher subsequent growth whereas regions experiencing capital flight experienced growth declines (Daams et al. 2024a,b).

In terms of the economic geography of these shocks, in the specific case of the UK, as we see in Figure 2A., in the pre-crisis years, investors were broadly sanguine regarding the investment offerings and opportunities across almost all UK regions and cities. Accordingly, both the absolute levels of the urban risk-premia and investment yields as well as their interregional differences were low across the whole country (Daams et al. 2024a). Not surprisingly, therefore, the correlation between the business cycles of London and other UK regions was higher during this period than the downward long-run trend in these correlations would imply (Harvey 2013), and this period of market optimism also marked the start of the public-private rejuvenation of many of the UK's city centres (ODPM 2006a,b).

Figure 2. Maps of UK Regional Mean Risk-Premia and their Pre- to Post-Crisis Change.

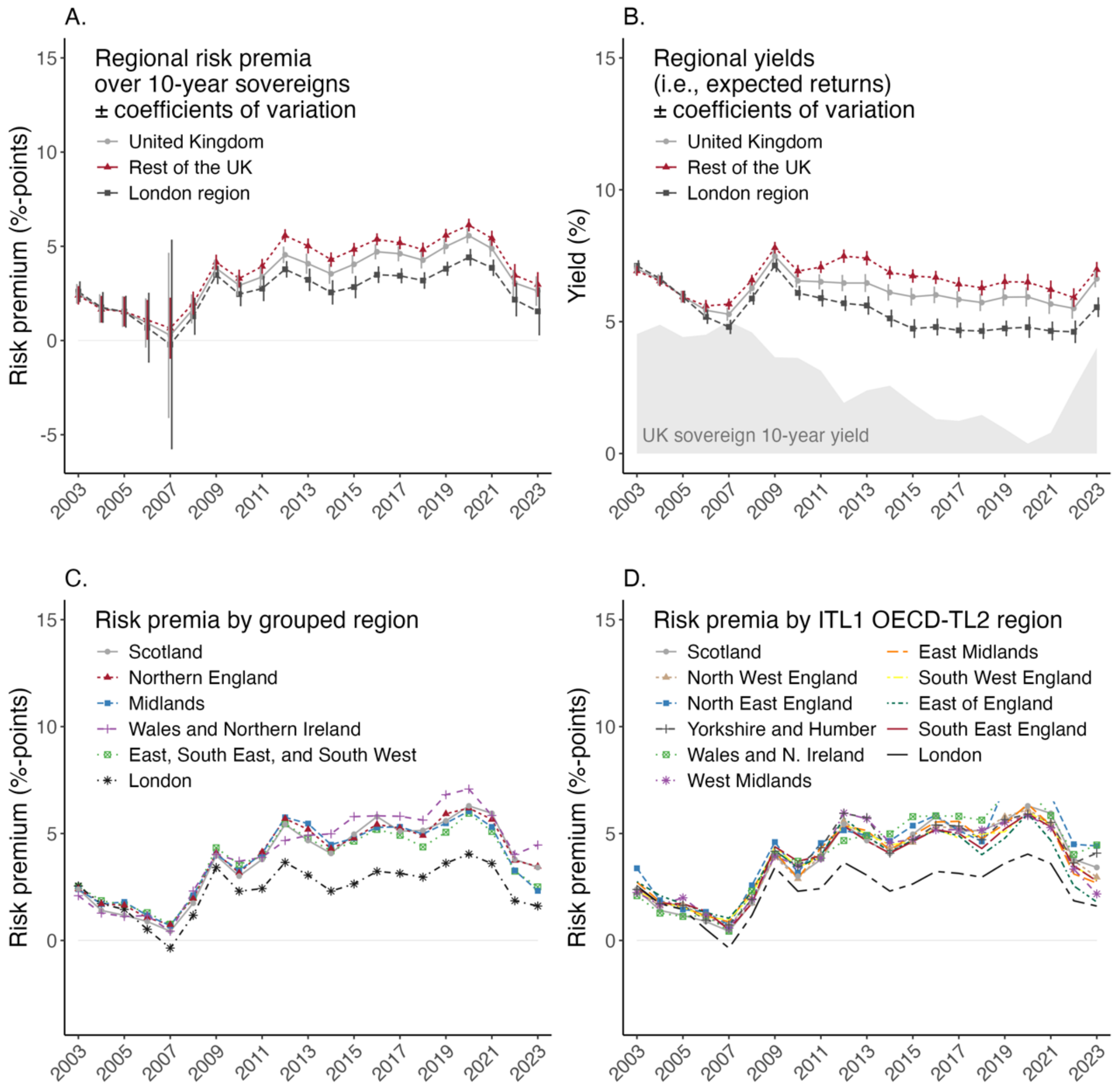


Source: Daams et al. (2024a)

This period of sanguine investment sentiment across UK regions was abruptly brought to an end by the capital shocks associated with the 2008 crisis. The economic geography features of these pre-to-post-crisis capital market regime changes are remarkably similar between the USA and the UK, except for the number of 'safe havens' sought out by investors. In the USA, these 'safe haven' cities numbered approximately the twenty largest cities (Daams et al. 2024b), whereas in the UK, the capital flight-to-safety was solely to London and its immediate hinterland (Daams et al. 2024a).

As we see in Figure 2B., in the wake of the 2008 global financial crisis, the global investment community, in effect, partitioned the UK economy into two fundamentally different investment zones, namely London and its immediate hinterland versus the rest of the UK regions, and this partitioning in risk-pricing broadly persists today, more than a decade and a half after the crisis.

Figure 3. London and the Rest of the UK Risk-Premia and Investment Yields



In order to discuss these patterns in more detail, in Figure 3A we plot the average investment risk-premia over the sovereigns for London, the rest of the UK excluding London, and the UK as a whole, for each respective year 2003-2023, and we also incorporate the coefficients of variation. In Figure 3B we repeat the same exercise for the investment yields, but here we directly compare the investment yields with the 10-year yields on sovereigns. What we see in both Figures 3A and 3B is that in the years prior to the 2008 crisis, both measures of investment risk varied very little across UK regions, as has already mentioned above, but in the years after the 2008 crisis, the risk spreads between London and the rest of the UK widen dramatically. Moreover, in Figure 3B we see that between 2008 and 2015, the investment yield values follow the yield path of UK gilts very closely, as large-scale QE Quantitative Easing was initiated by the Bank of England. In marked contrast, QE appears to have had little or no real effect on the rest of the UK regions, with the overall result being that the UK as a whole was only partially responsive to QE.

In Figures 3C and 3D we can observe these effects in more detail. Figure 3C plots the average risk premia across groups of regions while Figure 3D plots them according to each individual region. In both cases the dramatic post-crisis partitioning between London and all other UK regions very apparent. Yet, within the other UK regions there is also subtle ordering of regions, with southern regions treated more favourably by capital markets than more peripheral regions, largely along the lines of the pre-existing core-periphery structure of the UK economy (McCann 2026). The interregional risk-premia and investment yield spreads between London and the rest of the UK are currently of the order of 150-250 basis points. With the onset of the 2008 crisis, much of the UK outside of London and its immediate hinterland was shocked into junk bond pricing territory, and these regions remain there more than a decade and a half after the crisis.

In order to examine the more detailed urban aspects of these regional capital shocks, at various points in following figures we use data on comparable real estate investments in the western European[3] cities and regions as a counterpoint against which we can benchmark the UK changes in risk-premia and investment yields[4].

Figures 4A, 4B and 4C use continental European countries as a counterpoint for each of the years 2003-2023, and we compare the urban risk-premia for the whole of the UK, for just London, and for the rest of the UK, respectively, with respect to the rest of Europe. Figures 4D, 4E and 4F, then repeat the same exercise for urban investment yields, comparing these also with the respective national 10-year sovereigns.

Figure 4A shows us that the urban risk-premia as a whole differ only slightly between the UK and the rest of continental Europe over this period. In the pre-crisis period, UK cities enjoyed a risk-premia advantage over continental European cities, whereas after the 2008 crisis this advantage largely disappeared. However, this overall profile masks profound internal differences within the UK. As we see from Figure 4B, London displays an ongoing risk-premia advantage over other parts of Europe, although this advantage has narrowed and largely disappeared in recent years. In contrast, as we see in Figure 4C, across the rest of the UK as a whole, in the pre-crisis period other UK cities enjoyed a risk-premia advantage over continental European cities, whereas in the post-crisis era they continually display a systematic risk-premia disadvantage. As we see in Figures 4D, 4E and 4F, these same broad patterns also hold when we consider the urban investment yields and how these have moved with respect to the respective 10-year sovereigns[5].

Interestingly, from Figure 4E we see that London's positive responsiveness to QE appears to have been truncated in 2016, the year of the Brexit referendum, since which London has lost its investment pricing advantages with respect to continental Europe.

[3] For 2003-2023 we have 5,428 investments in continental Europe with full yield data.

[4] Our UK and European data classify cities according to the OECD definition of metropolitan urban areas, a geographical definition which covers more than three-quarters of the UK population (McCann 2016).

[5] In Figures 4D, 4E and 4F, the yields on 10-year UK gilts are highlighted in a lighter grey and the darker grey represents 10-year continental European yields.

Figure 4. Risk-Premia and Investment Yields across UK Metropolitan Urban Areas

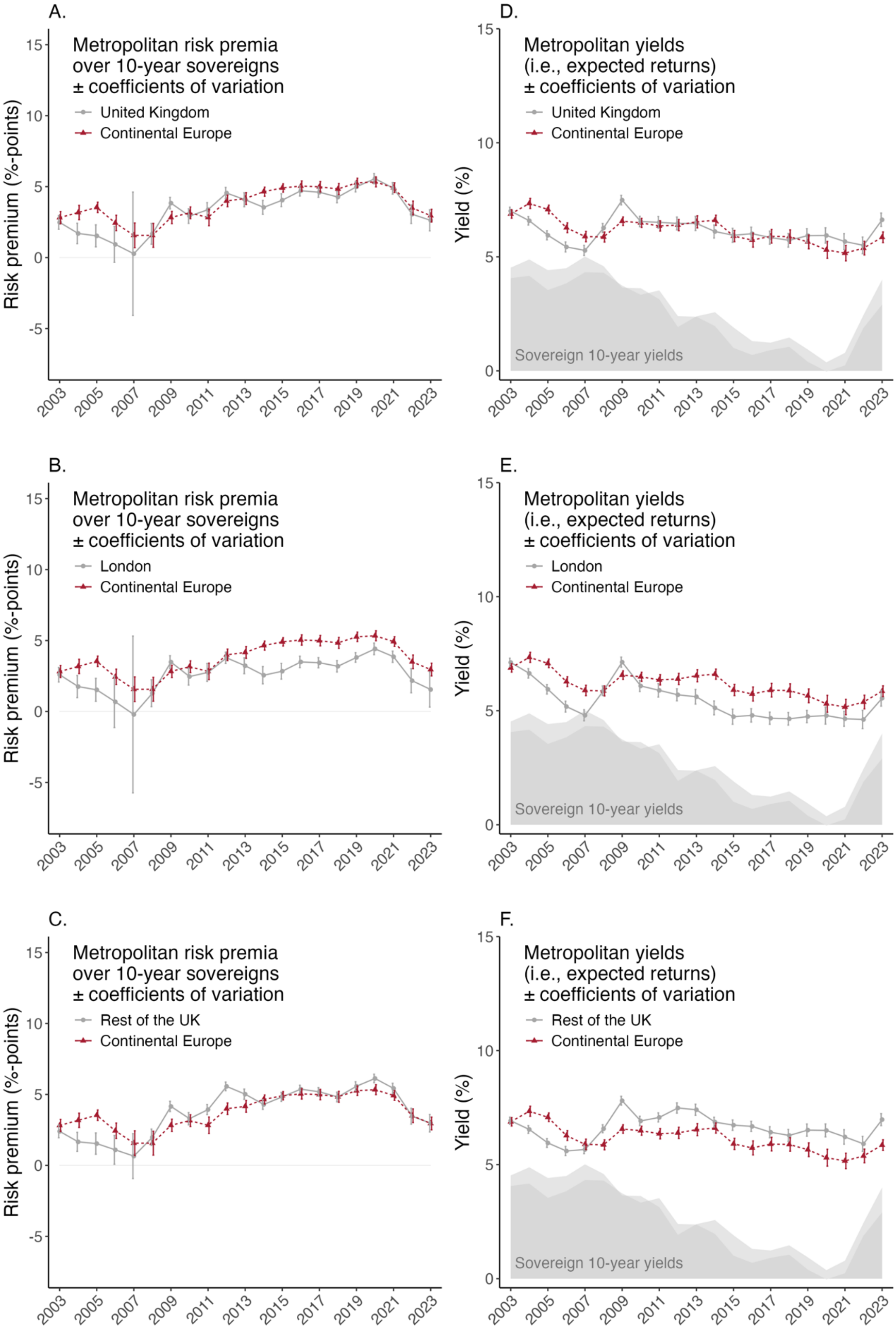


Figure 5. Risk-Premia and Investment Yields across UK Central Business Districts CBDs

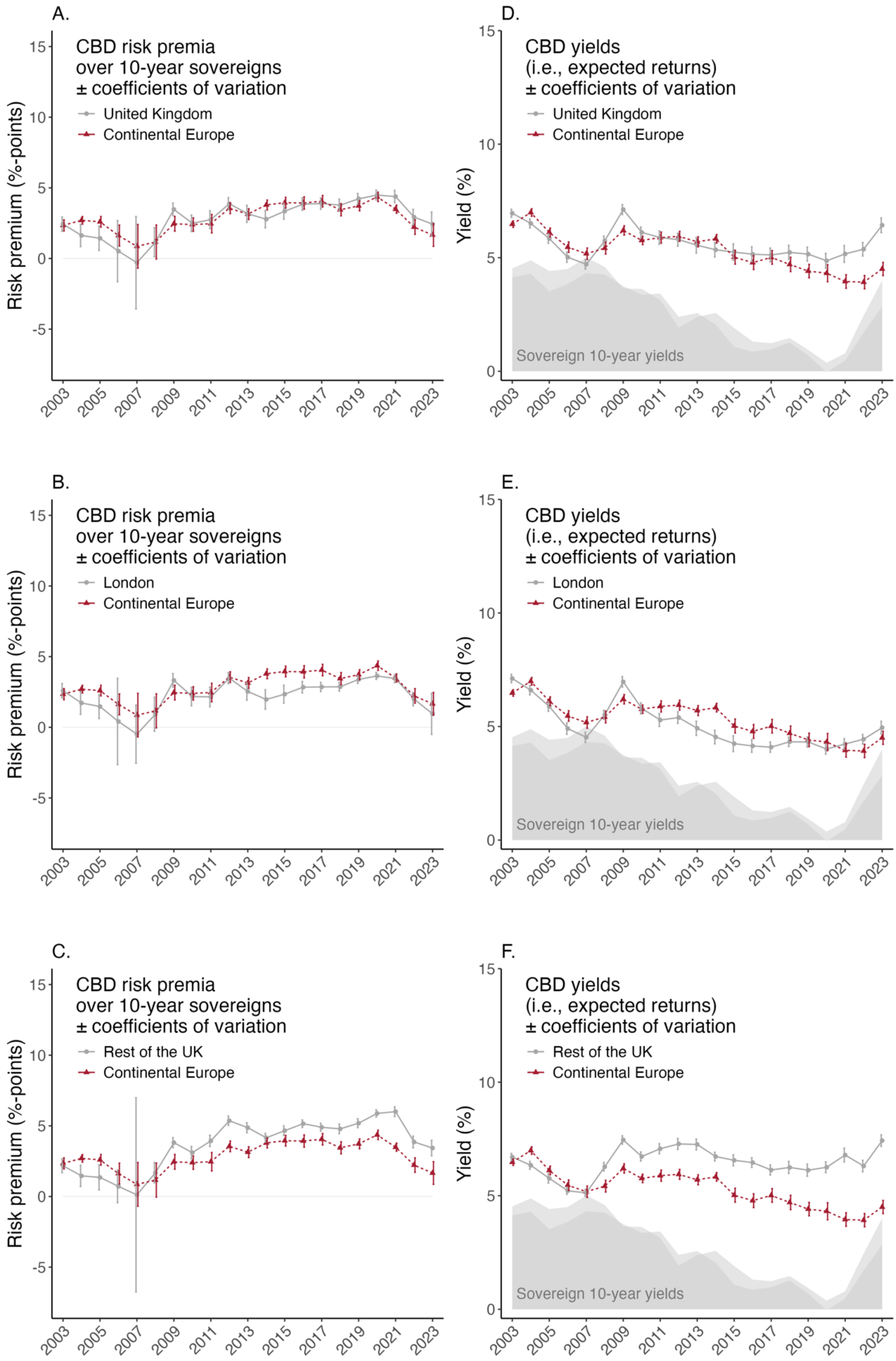
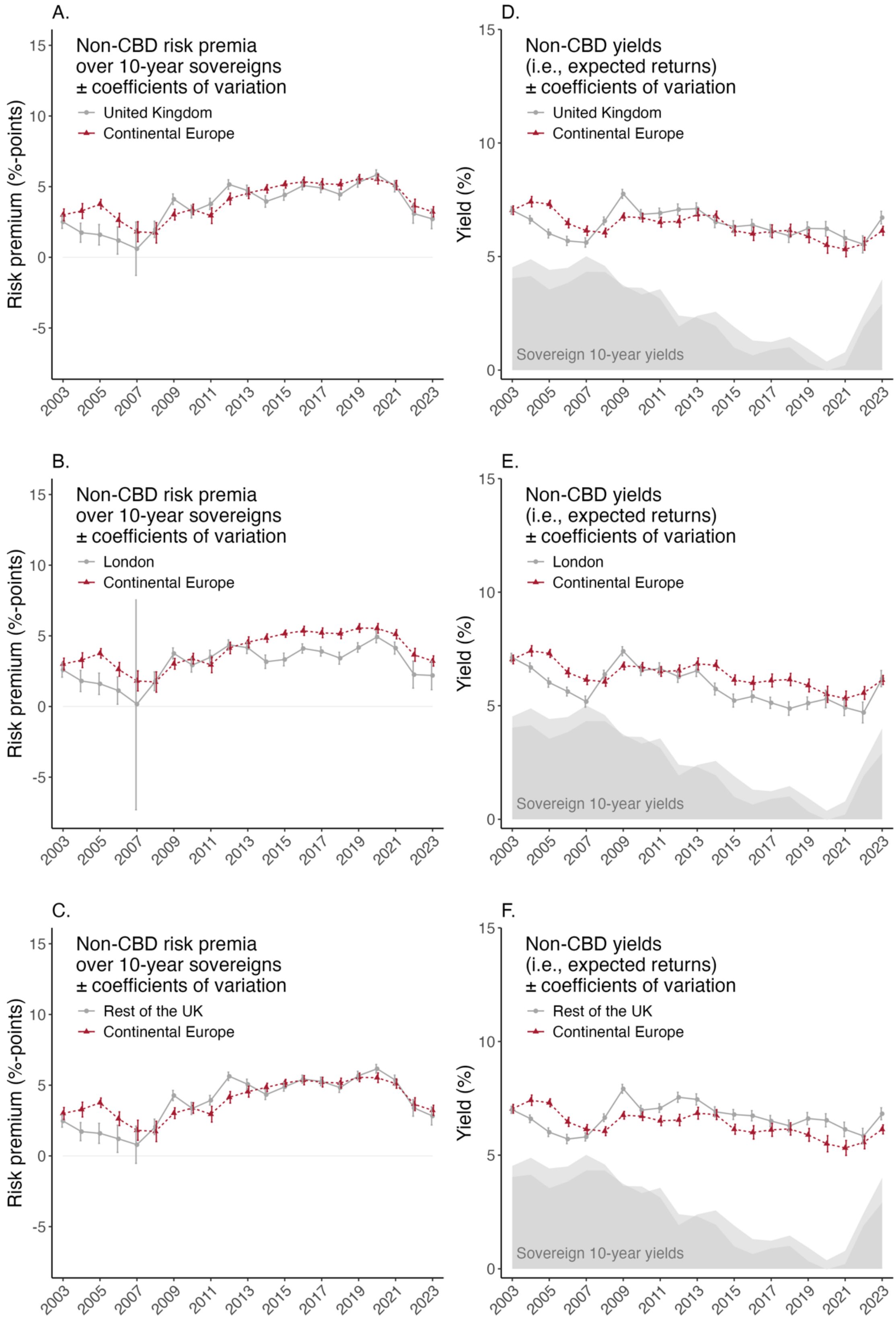


Figure 6. Risk-Premia and Investment Yields Outside of Urban Centres



Our data allows us to investigate these issues in even more detail. In particular, given the importance of agglomeration and clustering in the urban and regional economics literatures, it might appear somewhat strange that investors' perceptions of UK cities other than London should change from being relatively so positive to so negative with the onset of the 2008 crisis.

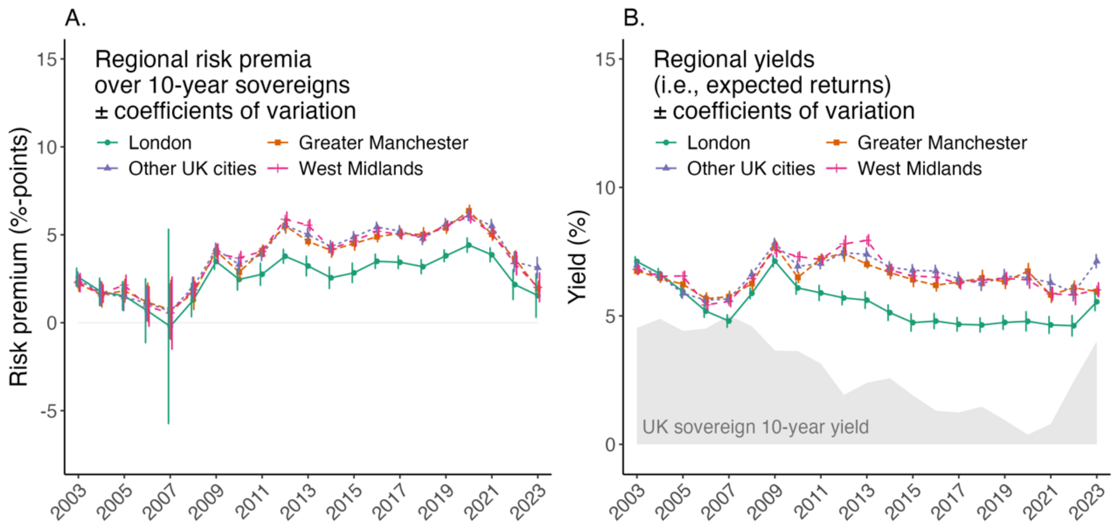
The various components of Figure 5 therefore repeat exactly the same exercise as for Figure 4, but only for investments which are clustered together in the central business districts (CBDs) of the cities, whereas Figure 6 undertakes this exercise for those investments which are located outside of the central business districts of the urban areas. Again, we use continental Europe as the counterpoint.

In Figure 5A and 5D, when we compare with Figures 4A and 4D, we see that the risk-premia and investment yields of investments in UK city centres are much more unfavourably priced than UK investments in general, and this adverse risk-pricing penalty appears most clearly after the 2016, the year of the Brexit referendum. However, again, this observation is composed of two rather different phenomena. As we see when comparing Figures 5B and 5E with Figures 4B and 4E, both London's central business districts and London as a whole, manage to maintain their risk-pricing advantages over continental Europe until 2016, after which this disappears. In marked contrast, however, as we see in Figures 5C and 5F, the central business districts of other UK cities faced dramatic adverse capital pricing effects since the 2008 crisis, which subsequently widened after the 2016 Brexit referendum. Today, the risk and yield spreads between other UK city centres and both London and continental Europe, are of the order of 250-300 basis points, a gap which is similar to the yield differences between UK gilts and the sovereigns offered by Romania and Chile (Daams et al. 2024a).

From Figure 6 we see that while the risk-premia and yield patterns for urban investments outside of UK city centres are similar to those displayed in Figure 4. At values of 50-100 basis points, the actual risk-spreads between non-clustered UK investments outside of London and non-clustered investments either in London or in continental Europe, are much smaller than for those in urban centres. As such, in terms of capital markets' risk-pricing, it was UK urban centres which have borne the brunt of the post-crisis capital shocks, not smaller places and less clustered locations (Daams et al. 2024a), and that these adverse risk-pricing effects appear to have been accentuated by Brexit. Although it is a popular narrative and political and media arenas, across the UK as a whole, our data demonstrates that there has been no 'cities versus towns' partitioning in terms of investor attractiveness. Instead, what the UK has experienced in the post-crisi period are adverse capital market shocks to the city centres outside of London and its immediate hinterland, with the UK's already-prosperous places being favoured over other places (Daams et al. 2024a). The evidence suggests that that start of the rejuvenation of UK cities which occurred around the time of the new Millennium (ODPM 2006a,b) was dramatically curtailed by the onset of the 2008 crisis, and subsequently accentuated by Brexit.

Our data suggest that there is one piece of potentially good news, which if confirmed with further annual data would be an important lesson. In Figure 7 we see that in the last few years since 2021 there are two metropolitan urban areas which appear to be once again converging to London levels of risk-pricing and investment yields, and these are Greater Manchester and the West Midlands. These are the two largest Mayoral Combined Authorities, and also those which are the most advanced in terms of devolution capabilities and powers. As of late 2023, both their investment risk-premia (over sovereigns) and investment yields were converging to those of London, whereas this was not the case with other UK cities.

Figure 7. Risk-Premia and Investment Yields of Selected Cities



Governance devolution has been posited as part of a potential solution to the UK's regional and urban divides (McCann 2016), and this observation provides some very tentative initial evidence that governance devolution may be encouraging more favourable investment sentiment in some places outside of the London area. However, public governance devolution, alone, cannot narrow regional divides in all areas without other fundamental changes to the UK's economic system, of which reforms to the financial and banking system would appear to be crucial. As we see here, the manner in which capital and investment markets perceive and function in UK regions is central to the whole UK national growth problem, and finding ways to rejuvenate the confidence, interest in, and activities of financial markets in UK regions would appear to be central to the problem of promoting growth in the UK. Indeed, the scale of the numbers put forward here implies that this may well be the single most important issue to address.

Our analysis demonstrates that today, the capital market risk-pricing partitioning of UK cities and regions is on a continental-wide scale, with interregional investment risk-spreads within the UK which are of the order of 250-300 basis points, the sovereign pricing range between the UK and Romania or Chile. In addition, our analysis here implies that monetary policy, and in particular QE Quantitative Easing, only had beneficial effects on the London economy, and appears to have had no beneficial traction whatsoever on most of the rest of the UK. Ironically, the Bank of England assumes in its models that monetary policy is systematically neutral across regions, and that this was also assumed to be the case in particular during the period of QE 2008-2014 (Bunn et al. 2018). Our findings, however, suggest that in the post-crisis era this was a fundamentally mistaken view, and that monetary policy traction was highly regionally concentrated, and may well have exacerbated the regional divides between London and the rest of the UK.

The evidence presented here suggests that UK national growth cannot be increased unless we are able to find ways to rejuvenate investors' long-term and large-scale confidence in the economically weaker UK regions. In particular, rejuvenating the central business districts (CBDs) of the UK's second-tier and third-tier cities would appear to be absolutely crucial for spurring wider regional growth. The fact that the effects of monetary policy, and in particular

QE quantitative easing, are so regionally concentrated, suggests that regional financial transmission mechanisms within the UK are highly ineffective and overly skewed towards London. This raises the question as to the effectiveness of the whole of the UK banking and financial system in serving the UK interregional economic system, and in particular in helping to rejuvenate the commercial centres of cities in non-core regions.

The UK Banking and Financial System: How We Got Here

What this all points to is that the UK has a highly segmented capital market – the type of segmentation that one observes across countries and regions of the world. In financial terms, it really is as if "the north is another country".

How can this be, and how has it arisen? The answer is the history of how finance has evolved in the UK over the past two hundred years. During the industrial revolution at the end of the 18th and the beginning of the 19th century, Britain had a very localized banking system. Local banks sprung up all over the country and played a critical role in financing the industrial revolution, which made the UK "the workshop of the world" (Mayer 2013 and 2018).

However, those local banks were very dependent on their local economies and when there was a downturn in those economies, banks collapsed. There were persistent bank failures during the 19th century resulting in banking crises, culminating in the City of Glasgow Bank collapse in 1878. The response of the Bank of England was to seek mergers between banks which shifted their headquarters to London. The result was that, by the end of the 19th century, commercial banking in Britain comprised five banks headquartered in London.

Meanwhile, there was another very different type of banking emerging in Britain, namely merchant banking. This was banking that developed on the back of growing trade across the British Empire and the rise of the British trading companies. As a result of these two developments, British banking shifted from being something focused on funding the growth of small firms across Britain to being concentrated in London and increasingly devoted to funding international trade. It was as if banking had turned its back on Britain to devote itself to the more lucrative and prestigious Empire.

Similar processes were at work in equity markets. Following freedom of incorporation in the middle of the 19th century, stock markets began to appear everywhere in Britain at the end of the 19th century. For example, stock exchanges opened "in Oldham (in 1875), Dundee (1879), Cork (1886), Belfast (1897), Cardiff (1892), Halifax (1896), Greenock (1888), Huddersfield (1899), Bradford (1899), Swansea (1903), Nottingham (1909), and Newport (1916)" (Campbell, Rogers, and Turner, 2016). For a period, it looked as if stock markets were taking the place of the local banks in providing SMEs with locally-based finance.

However, in the aftermath of World War II, the locally based individual investors were replaced by institutional investors, predominantly life insurance companies and pension funds, headquartered in London, and individual share ownership declined rapidly. Local stock markets merged, closed, and eventually consolidated in one market in London – the London Stock Exchange.

So, by the beginning of the second half of the 20th century, finance in Britain was consolidated in London with a predominant focus on international capital markets. However, at least it retained a strong presence of domestic financial institutions – commercial banks, merchant banks, pension funds and life assurance companies – which had an interest in British companies. The final nail in the coffin of that was "Big Bang" – the liberalization of what had previously been dominant restrictive practices in the City of London.

The result was the merging of commercial and merchant banking in US style investment banks and the acquisition of domestic financial institutions by foreign owners, keen to get their hands on the increasingly lucrative trading in London. Most seriously, the dominance of UK pension fund and life assurance companies of the ownership of UK equities waned from around 50% in the 1960s to less than 5% today. The UK financial market is therefore now characterized by little presence, little finance and little interest in the regions of Britain and the commercial opportunities that might exist there. This centralisation of finance and an ever-dwindling regional presence mirrors what was also taking place in an array of other UK governance arenas (McCann 2016). As a result, not only is Britain's system of government highly centralized, so too is its financial system.

Banking on Britain

By far and away the most important source of finance for the emergence and growth of small and medium sized enterprises (SMEs) is bank finance. The relationship of companies with their banks is critical to their ability to fund their growth and development.

At first sight, banking in Britain would appear to be well represented across the country. Bank branches and bank lending are reasonably evenly spread across the regions,[6] and, while levels of bank lending are concentrated in the south-east, as a proportion of business activity, they too are reasonably equally distributed across the country.

However, it is not only the number of banks in a region that matter, but so too does the nature of the relationships between banks and their borrowers. One of the most successful and fastest growing commercial banks in Britain over the past decade is not a British bank. It is the Swedish bank Handelsbanken (Kroner, 2011). The most important distinguishing feature of the bank for these purposes is its governance. Most banks are run in a hierarchical fashion from the top, which has intensified since the financial crisis as regulators have required banks to have risk committees, monitoring and managing risks and reporting to the board of directors on risks throughout their businesses.

Handelsbanken follows the opposite principle of delegating decision-taking down the bank and making branches, especially branch managers, responsible for most decisions concerning the products they sell, to whom, at what prices and how they are marketed. Such is the degree of devolved authority that the mantra of the bank is "the branch is the bank".

The significance of this is that it embeds the purpose throughout the organization, and it confers discretion on branches to build relations of trust with their customers. They can avoid the type of bureaucracy that afflicts more hierarchical banks and can instead base decisions about, for example, loans on information from relations with their customers. To achieve this, Handelsbanken places emphasis on selecting branch managers, ensures that they are thoroughly versed in the principles and values of the bank, and then leaves them to run their branches as they see appropriate.

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[6] The number of bank branches per 10,000 in Britain varied between 1.1 in the East Midlands and Yorkshire to 1.4 in London and Wales in 2022.

In other words, Handelsbanken places trust in its employees to make decisions that are in line with the principles and values of the bank, which in turn allows the branches to establish relations of trust with their customers. That is not possible in more hierarchical banks which use high powered financial incentives to align employee interests with those of the bank, because of the misalignment this creates with the interests of their customers.

In essence, Handelsbanken has recreated traditional local relationship banking in a large multinational financial institution where its business grows with its corporate customers over the long-term, in contrast to fee-based income earned from transactions in the short-term. Branch managers in Handelsbanken do not have to refer lending decisions up the bank, wait for responses from their seniors before telling the borrower that they are terribly sorry but their application has been declined. They can look people in the eye, gain a real understanding of their and their businesses' nature and prospects, and use the most important of loan criteria, human judgment, to take a decision.

This allows the bank to establish long-term relations with their customers in a branch system where essentially every employee is a relationship manager. This is sometimes termed 'soft' or 'tacit' knowledge in contrast with the hard, 'generic' form of knowledge that come from readily available data through, for example, artificial intelligence and fintech, and includes not only assessments of people but also places and puts the firm and its employees in the context of local conditions in which the firm is operating.

The needs and opportunities of firms in the north of Britain are quite different from similar ones in the south. Lenders must be in place and have a deep understanding and appreciation of the history, aspirations, and challenges of the communities in the localities in which they are operating. The physical distance between a small firm and a large bank limits the 'soft' information available to a bank in assessing the credit worthiness of a borrower and reduces the likelihood of credit being provided where needed (Agarwal and Hauswald, 2010, Bellucci, Borosiv and Zazzaro, 2014).

Companies that suffer interruptions to relationships with their loan officers are less likely to be able to renegotiate loans when they need to, and they are also more likely to experience worse renegotiated terms and end up seeking alternative sources of finance (Papoutsi, 2021). This is especially damaging for small and medium sized enterprises (SMEs), particularly those in more distant locations (Berger and Udell, 1995, Canales and Nanda 2012, Degryse and Ongena 2005, and Salas and Saurina 2009). This in turn exacerbates the decline of left-behind places as bank branch closures lead to persistent falls in local small business lending, particularly during recessions (Nguyen 2019).

Germany is often held up as an example of a relationship banking economy. 'Sparkassen' are savings banks, which are small to medium in size, and which are legally focused on providing services to designated municipalities and counties. As decentralized banks, their focus is on supporting the development of regional economies typically through close relationships with the local businesses to which they lend. Roughly 99% of all German businesses are SMEs which typically do not have access to capital markets (Simpson, 2013). The Sparkassen meet their funding needs by acting as their 'Hausbank' (house bank) for their respective municipalities. They reduce the financial constraints on SMEs and play a critical role in making credit decisions for struggling SMEs where soft information is particularly important (Flogel, 2018).

Financial re-regulation and consolidation in the aftermath of the 2008 crisis increased concentration in both the British and German national banking systems but the outcomes were very different in countries. It led to a much greater organizational and spatial concentration in the UK, with only London gaining, whereas Germany did not experience anything equivalent (Wójcik and McDonald-Korth, 2015, Klagge, Martin and Sunley, 2018). As a result, bank lending to manufacturing SMEs in the British regions was adversely affected by the increasing distance between the banks and their customers (Degryse, Matthews and Zhao 2018). In contrast, in Germany, 40 per cent of credit extended to SMEs came from the local and regional savings and cooperative banks (Gartner and Flögel 2013).

It is not only German banking that is more local and relationship-oriented than British banking, but so too is banking in the US, where banks are regulated at the national and the state level. There are approximately 5,000 community banks in the US which specialize in banking for local SMEs and family businesses and these banks account for some 40 per cent of small loans to business (The Economist, 2019). The Federal Deposit Insurance Corporation (FDIC) plays an important role in supporting community and locally based banks in the US by providing insurance, regulatory, and receivership services (Beck, Levine and Levkov, 2010, Becketti and Morris, 1992, Boyd and Gertler, 1993, and Krahnen and Schmidt, 2004). As a result, community banking has had a positive impact on regional development, in particular employment growth in small businesses in the US and it strengthened regional resilience to declines in employment growth and new business formation during the 2007 to 2009 fiscal crisis and recession (Petach, Weiler and Conroy, 2021).

Inequitable Equity

The disparities in the prevalence and functioning of financial institutions in the UK are even more in evidence in equity markets. Business angels are heavily concentrated in London and the South-East with between 50 and 60% of the total angel population being located there. That means that other parts of the country are largely devoid of business angel communities. The consequence is that many would-be start-ups elsewhere are not only deprived of equity to get going but also do not receive the advice and support they need from mentoring and networking to grow their businesses.

After the first rounds of finance, later stages involve the participation of more formal institutions, in particular venture capital and private equity firms in the provision of equity finance. They are the essential link between institutional investors in capital markets, in for example the City of London, and the entrepreneurs developing and growing their businesses in the regions. The provision of equity finance requires engaged, informed investors, intermediating between the large diversified institutional investors in major international financial centres and small growing businesses across the country.

Like business angels, venture capital firms are a vital source of advice and information as well as finance on how businesses should grow. But in Britain they too are heavily concentrated in London and the South-East, with some two-thirds of venture capital firms based there, leaving many parts of the rest of the country without the development capital needed to scale-up their businesses.

Furthermore, much private equity in Britain (between 70 and 80%) is focused not on funding new and growing businesses through venture capital but on restructuring existing firms, especially the buyout of companies listed on stock markets by their management. So, the prospects of raising equity finance for entrepreneurs looking to start and grow their businesses beyond the immediate vicinity of the City of London are bleak.

The fragmented nature of UK capital markets reflects the absence of the piping that connects the large pools of capital in the City of London with the regions of Britain. As in banking, at the heart of this is the relevance of distance in determining the provision of finance to small and growing firms, and entrepreneurial firms starting their businesses and especially scaling them up to national and international levels. The provision of finance to such companies depends on the proximity of lenders and investors.

This reflects the significance of 'specific and tacit' knowledge about the nature of SMEs, the character and competence of the individuals involved, and their honesty and reliability in using the funds provided to best purpose. There is a great deal that machine learning and fintech can do in terms of screening borrowers using 'generic and codified' knowledge that comes with large data banks and artificial intelligence, but there is a limit to the extent to which they can build trust and the required levels of confidence to satisfy investors.

Furthermore, the process of scaling up businesses depends on long-term patient capital which is crucially dependent on committed relationships rather than just short-term transactional contracts. These benefit from the proximity of providers and users of finance that facilitate repeated interactions. So, distance matters and the absence of local financial institutions in the regions of Britain is a serious impediment to capital flowing from the pools in London to SMEs and entrepreneurial businesses in the regions.

It is not just financial institutions that play a critical role in this, but so too does the whole professional infrastructure on which they depend. Accounting, consulting and law firms are required to provide the advice, expertise and knowledge that both investors and firms need, and those too are in serious short supply in many of the regions of Britain.

In other words, what is required to connect the City of London with the regions are local ecosystems of banks, business angels, private equity, venture capital and professional service firms working in conjunction and supporting each other in funding and growing local businesses. The absence of one part of that ecosystem can undermine the function of the remainder because lenders and the providers of debt finance depend on firms having access to equity capital, and vice versa, and all depend on a full range of advisory services.

With the collapse of the British heartland in the early 1980's came the demise of this financial and professional infrastructure, and it is the absence of this that is now contributing to the segmented nature of the UK capital market. It needs to be rebuilt from the ground up in localities if the UK is to re-establish an integrated financial system in which the strengths of London's financial markets are reflected in the regions, and the City of London turns once again to funding the whole of the country.

Conclusions: Rebuilding British Business in the Regions

This paper points to a long-term trend towards a remarkable decline of capital market integration within the UK and also a serious deterioration of integration since the financial crisis and Brexit. Most regions of the UK today face extremely difficult capital market conditions, and the degree of fragmention of the UK's internal capital market is at a scale that is greater than that which is observed across countries within Europe. The fragmentation reflects the fact that the UK banking system has become increasingly centralised and top-down in nature, with an ever-diminishing regional footprint (Mayer et al. 2021; Mayer 2024a and 2024b).

Underpinning this fragmentation is a disconnected UK financial system concentrated in the City of London and poorly linked to the rest of Britain, with a serious lack of financial and professional infrastructure outside of London and the South-East. As currently constituted, the overly London-centric and regionally absent UK banking system would appear to be entirely ill-suited and ill-equipped to take on the role of rejuvenating the commercial business districts of UK cities. Fundamental reforms to the UK banking and financial system as well as the professional services ecosystem, all aimed at galvanising the local financial ecosystems, would therefore appear to be crucial to help kick-start a revival in UK regional and national economic fortunes (Mayer et al. 2021; Mayer 2024a and 2024b).

However, this is not to say that financial and banking reforms alone will solve these regional productivity growth issues. The other drivers of new business creation and growth in the regions are of course critical as well. The newly-devolving public governance sector needs the tools to finance regeneration, and indeed a lack of devolved authority at the level of local and regional government, an absence of funding and an inability to raise financial resources at the local level, have played a key role in the failure to stimulate regeneration. As such, greater decentralisation and devolution of the UK financial system must go hand-in-hand with allied reforms to how land markets interact with the land-use planning system[7], and changes in the ways in which local and regional authorities are able to use their powers to help to de-risk and promote investment by SMEs, investors in commercial space, large companies and other financial institutions.

Other devolution-related reforms for spurring local economic development focussing on education and skills have been discussed at length in many arenas, and these variously include changes in remits of further educational colleges, training bodies, and our UK-wide system of world-class universities and research institutions. Collectively, these institutions provide the human capital, ideas and skills which underpin the local entrepreneurial start-ups, spin-outs, and scale-ups of SMEs. Allied with investments by large corporations, the role which these sources of human capital can play in rejuvenating UK cities needs serious reconsideration.

But reforms to the UK financial system have been largely a missing element in the debate to date (Mayer et al. 2021). A collaborative determination of all UK financial institutions, led by organizations such as the British Business Bank and the UK Infrastructure Bank, to recreate local capital markets in the main cities of Britain, will send a strong signal that this is a real partnership between the public sector at the local and national levels, aimed at helping the private sector to regenerate left-behind places (Collier, 2024).

The scale of the problem revealed by risk premia spreads across the UK is immense. But so too is the potential for recovery and regeneration if the vast pool of private sector capital in

[7] For details see the two TPI (2024) Briefings "Access to Capital and Finance: Strategic Context, Challenges and Policy Recommendations" and "Land Use and Planning Reforms: Strategic Context, Challenges and Policy Recommendations", The Productivity Institute, 01 August 2024. The weblinks for these two documents are:
https://www.productivity.ac.uk/research/access-to-capital-and-finance-strategic-context-challenges-and-policy-recommendations/
https://www.productivity.ac.uk/research/land-use-and-planning-reforms-strategic-context-challenges-and-policy-recommendations/

London can be reconnected with the businesses, universities and goverments across all of the UK's regions.

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