what works centre for local economic growth

Rapid evidence review: Community finance

Introduction

Community finance institutions (CFIs) are an alternative to commercial financial institutions. CFIs normally have organisational structures that are mutual – profits are shared amongst members – or non-profit distributing – profits are reinvested into the businesses. They are more likely to be locally or regionally based. In the UK, types of CFI include credit unions, community development finance institutions, mutual societies, and co-operative banks.

This review considers the evaluation evidence on CFIs. This includes studies that compare the behaviour of CFIs to that of commercial financial institutions (for example, are they more likely to lend to small businesses) or evaluate the impact that CFIs have on local economic outcomes (for example, is employment more stable in areas where CFIs account for a larger share of the market). The primary way CFIs will contribute to local economic growth is if they improve access to finance for businesses. However, few studies look specifically at business lending, with most looking at either the overall activities of CFIs or their presence in an area.

This rapid evidence review informed our briefing on assessing the local economic impacts of improving access to debt finance.

Things to consider

Need for more evidence

- We need more evaluations, particularly of impacts on access to finance, business performance, employment, and productivity.
- Given variations in banking systems across countries, there is a need for UK-based CFIs to be evaluated. None of the studies we identified are from the UK.

- We did not find any studies that evaluated CFIs that provided other types of finance (for example, insurance, social bonds, etc.) or about the impact of using other financial resources, such as local pension schemes, to benefit local communities. Again, it would be good to fill these gaps.

Policy lessons are covered in the improving access to debt finance briefing.

Evaluation evidence

What is community finance?

Most financial services in the UK are provided by private sector businesses, such as commercial banks and insurers. Mutually-owned building societies also played an important role before many societies, including most of the largest, demutualised in the 1990s.

Perceptions that commercial financial institutions, especially banks, are not adequately serving community needs has led to increasing interest in supporting CFIs. In the UK, these include credit unions, community development finance institutions, mutual societies, and co-operative banks. This review focuses on CFIs that offer banking services.[1] Ideally, it would draw on studies evaluating the provision of debt finance to businesses as improving access to business finance is the main way CFIs could impact on local economic growth but most studies look at CFI activities as a whole and are not disaggregated by customer type.

Understanding the impact of community finance

Our evidence reviews use studies that the What Works Growth team has scored as three or above on the Maryland Scientific Methods Scale (SMS), which classifies evaluations based on methodological robustness and implementation.[2] Our toolkits and rapid evidence reviews also include studies with a score of two or above when these add to the evidence base (for example, where there are no or few studies that score SMS 3 on a policy or outcome). More than three-quarters of the studies included in this rapid evidence review score SMS 3 or above.

Our search identified nine evaluations. One was scored as SMS 4, six as SMS 3, and two as SMS 2. In summarising the evidence, we place greater emphasis on studies that use more robust methods. Annex 1 provides a summary of each study.

Studies are organised by outcome – access to finance, employment, inequality, and economic growth. All the studies on 'access to finance' consider the activities of CFIs (for example, are they more likely to lend to small businesses) other than one that looks at behaviour of borrowers. For other outcomes, there are a mix of studies looking at the activities of CFIs, and at whether their presence in an area has an impact.

As studies come from several countries, each with their own banking system, many different types of CFI are included in this review. We use the terminology from the original study. However, given differences across countries we interpret the findings as assessing the impact of CFIs, rather than comparing different types of CFI. Annex 2 provides details on the different types of financial institution mentioned in this review.

As always, be cautious of findings based on a small number of studies.

1 Some CFIs offer other financial services, such as insurance.

2 For more information on how we rank the robustness of evaluations, see our introduction to the Maryland Scientific Methods Scale.

Evidence on impacts

Access to finance

One of the main rationales for supporting CFIs is that they will be more willing to lend to local businesses, improving access to finance.

Two studies look at lending. One study is SMS 3 and one SMS 2.

- CF-1 (SMS 3) finds that co-operative and savings banks smooth their lending cycle – decreasing their loan supply less than commercial banks following an increase in the short-term interest rate and vice-versa. During the 2008 to 2011 financial crisis, this smoothing was only observed for co-operative banks.
- CF-2 finds that the number of small business loans provided by community banks is 30 percent higher than non-community banks, whilst the dollar amount is 74 percent larger. The effect is larger in non-metropolitan areas, where the number of small business loans provided by community banks is 73 percent higher than non-community banks, whilst the dollar amount is 85 percent larger. Physical offices appear to be more important for community banks, with 48 percent fewer small business loans (and 32 per cent lower dollar amount) provided by community banks in areas in which they have no offices, compared to non-community banks with no office.

Another study – scored SMS 2 – looks at behaviour of small business borrowers.CF-3 finds that relationships with a bank are more important than the type of bank when small businesses seek funding. The study finds no evidence that small businesses prefer community banks or are more likely to have (strong) relationships with community banks.

This suggests CFIs may be more willing to lend to local businesses – and that lending may be more stable than from commercial providers – but more evidence is needed.

Employment

Two studies – both SMS 3 – look at the impact of CFIs on employment. Both look at employment stability – one within the local economy and one within the financial institutions.

Both studies find positive effects.

- CF-4 (SMS 3) finds areas where a higher proportion of bank assets are held by community banks have higher employment growth rates. A 10-percentage point increase in the community bank asset share leads to a 0.19 percentage points higher county employment growth rate over the medium-term. The study also finds that counties with higher community bank presence prior to the recession triggered by the global financial crisis (measured in this study as 2007 to 2009) experienced smaller declines in employment growth rates as a result of the recession.
- CF-5 (SMS 3) finds commercial banks are more likely than credit unions to increase employment during periods of asset growth, whilst decreased employment during the recession triggered by the global financial crisis (measured in this study as 2008 to 2010) was lower in credit unions than commercial banks. Combined this suggests credit unions have more stable employment than commercial banks.

Overall, the evidence suggests CFIs have a positive effect on employment stability – both internally and in the local economies they serve. Again, more evidence is needed.

Inequality

One study looks at the effects on inequality. CF-6 (SMS 4) finds that the presence of co-operative banks in Italian municipalities reduces income inequality, while commercial banks have no effect, and popular banks (an Italian financial institution, considered an intermediate model between commercial banks and co-operative banks) have a negative effect, leading to increased inequality.

Whilst this is an extremely positive finding (given the policy rationale behind supporting CFIs and the quality of the study), more evidence is needed.

Economic growth

Three evaluations – all SMS 3 – look at the relationship between CFIs and economic growth.

All the studies find positive effects.

- CF-7 (SMS 3) finds mutual and co-operative bank credit (i.e. amount the banks lend), commercial bank credit, and venture capital investments all have positive effect on gross domestic product (GDP, a measure of output) per capita across German, Italian and Spanish regions.[3] Mutual and co-operative bank credit and venture capital both have a larger effect in regions whose GDP per capita is in the bottom quartile, while commercial bank credit has a larger effect in more highly developed regions.
- CF-8 (SMS 3) finds the size of the co-operative bank sector (co-operative bank assets as a proportion of regional GDP) has a positive effect on regional economic growth in France. The study recognises that whilst this may be because co-operative banks increase access to finance, it could reflect co-operative banks having a large share of the SME lending market in France. The study also finds the co-operative bank efficiency (return on co-operative bank total assets and return on co-operative bank total equity) has a positive effect on regional economic growth.
- CF-9 (SMS 3) evaluates the impact of banking sector on economic growth, measured by GDP per worker, at the municipality level. The study includes both measures of the size of the banking sector – measured as aggregate credits as proportion of local GDP – and the profit efficiency of banks. Both measures have a positive effect on growth, with co-operative banks having a stronger effect than other types of financial institution.

Overall, this suggests that CFIs may help increase economic growth. Other findings – such as the differential role of CFIs across areas with different characteristics or the role of market share or efficiency – provide useful insights but require further research. However, care should be taken in using these findings because the method used in these studies to deal with 'reverse causality' – from higher economic growth to more CFIs – is problematic for outcomes that evolve slowly over time (such as economic growth).

3 The study uses the first level administrative division in Spain (autonomous communities, equivalent to NUTS 2) and Italy (regions, equivalent to NUTS 2). As Germany is a federated state, it uses the states (more commonly known as Länder, equivalent to NUTS 1). More details on NUTS geographies are available from Eurostat.

Annex 1: Evidence on community finance

For this rapid evidence review, we looked for evaluation evidence on the impact of CFIs on local economic and wider outcomes. Given that we anticipated there would be relatively few studies, the search involved two stages. Using a wide range of terms, we searched for all studies relating to CFIs using methods that could potentially score SMS 2 or above. The search was undertaken using the EconPapers database. Studies were then reviewed to identify if they focused on local economic outcomes (such as employment, productivity or wages) or wider outcomes that may be important to local economies. We excluded studies that looked at the internal operations of CFIs. We focused on evidence from OECD countries (or similar), published in English. We considered any study providing before-and-after comparisons or cross-sectional studies controlling for differences between areas. We also included more robust studies that compare changes in outcomes in treated areas with changes in outcomes in similar non-treated areas.

We found nine studies. Of these, one was assessed as SMS 4, six as SMS 3, and two as SMS 2. In summarising the evidence, we place greater emphasis on studies that used more robust methods. Four studies are from US, two from Italy, one from France, and two cover multiple countries. This annex provides a summary of each study.

Access to finance

CF-1 (SMS 3, euro area) investigates whether different forms of bank ownership influence lending decisions in 12 euro area countries (i.e. countries that have adopted the euro as their currency, data mainly from Germany, France, and Italy). The study compares the lending behaviour of profit-maximising shareholder banks (i.e. commercial banks) and stakeholder banks (including both co-operative banks and savings banks) over the period 1999 to 2011, including analysing the pre-financial crisis period (1999 to 2007) and crisis period (2008 to 2011). The study uses a bank-level panel dataset based on BankScope financial statements (published by Bureau van Dijk), with annual observations for 4,352 individual banks – 861 shareholder banks and 3,491 stakeholder banks (of which 2,654 are co-operative banks and 837 savings banks). The study uses a fixed effects model with loans as the dependent variable and an Arellano-Bond type generalised method of moments (GMM) estimator. A full-period analysis shows that a 1 percent increase in the short-term interest rate reduces the loan supply by about 8.5 percent. The effect is larger pre-crisis (17 percent decrease) than during a financial crisis (7 percent decrease). Following an increase in the short-term interest rate, stakeholder banks decrease loan supply less than shareholder banks, suggesting stakeholder banks smooth their lending cycles. Co-operative banks continue to smooth the impact of tighter monetary policy on lending during the crisis, whereas savings banks did not.

CF-2 (SMS 2, US) studies the role of community banks in small businesses lending. Data is from Federal Deposit Insurance Corporation (FDIC) Statistics on Depository Institutions (annual bank financial data), FDIC Summary of Deposits (bank office data), and the Federal Financial Institution Examination Council (number and amount of loans to small businesses). Using a cross-sectional model, the study finds the number of small business loans provided by community banks is 30 percent higher than non-community banks, whilst the dollar amount of small business loans is 74 percent larger. The effect is larger in non-metropolitan areas, where the number of small business loans provided by community banks is 73 percent higher than non-community banks, whilst the dollar amount is 85 percent larger. Physical offices appear to be more important for community banks, with 48 percent fewer small business loans provided by community banks in areas in which it has no offices, compared to non-community banks with no office, and a lower dollar amount of 32 percent.

CF-3 (SMS 2, US) examines whether it is easier for small businesses to establish a strong relationship with small community banks compared to commercial banks. The study uses the 2003 Survey of Small Business Finance, which collects data from businesses with fewer than 500 full-time employees and contains details on their characteristics (income, expenses, and liabilities). Using a cross-sectional regression model, the study finds that small businesses are more likely to establish stronger relationships with their main banks, but the type of bank is not a key factor when seeking funding opportunities.

Employment

CF-4 (SMS 3, US) examines the impact of community banks on employment and other outcomes. It uses FDIC data on 51,578 community banks from 1983 to 2021. The independent variable is the share of community banks in a given county, measured by the ratio of all assets held by community banks over all assets in the county. Outcome variables include employment growth, house prices, and the rate of establishment births (the number of employer establishments per 1,000 employees). To avoid simultaneity bias, the community bank share is instrumented using a spatially weighted leave-out mean of the banking composition of neighbouring counties. The study finds that an increase in community bank presence has an effect on employment in rural and micropolitan statistical areas.[4] A ten-percentage-point increase in community bank asset share increases the annual county employment growth rate by 0.19 percentage points. Counties with a larger community bank asset share tend to be more resilient to economic recessions. A county whose assets are owned 100 percent by community banks has an employment growth rate 2.3 percentage points higher than a county of no community bank assets during the 2007 to 2009 recession. The study also finds that counties with greater pre-recession community bank presence experienced smaller declines in employment growth rate and establishment births during the recession, an effect that is most pronounced for small establishments in rural counties.

CF-5 (SMS 3, US) examines how US credit unions and commercial banks adjust their employment in light of economic shocks. A balanced bank-level panel dataset comes from combined bank balance sheets and income statement data provided by the National Credit Union Administration and Bankscope for the period 1999 to 2010. The final sample includes 6,845 banks over a 12-year period, with about twice as many commercial banks as credit unions. Both datasets are supplemented by annual state unemployment rates provided by the Bureau of Labor Statistics. Using a first-difference model with total assets as a proxy for bank output, this study examines changes in labour input within the credit unions and commercial banks in response to shocks in output or labour input costs. The study finds significant evidence of a higher employment adjustment elasticity for commercial banks than for credit unions during periods of asset growth, while there is no similar evidence of differences in employment adjustment following a decline in assets. The study also finds evidence of significant employment downsizing beyond predicted levels during the 2008 to 2010 recession for commercial banks and credit unions, with commercial banks downsizing more than credit unions.

Inequality

CF-6 (SMS 4, Italy) examines whether credit institutions affect income inequality. The study uses municipality-level data from the Italian Ministry of Economy and Finance, the statistical bulletin of the Bank of Italy, and province-level data from the Italian National Statistics Office, to build a province-level dataset (103 provinces) for 8,056 municipalities over the period 2001 to 2011. Using an instrumental variable approach, as well as fixed effects, this study finds that co-operative banks reduce income inequality, popular banks (an intermediate model between commercial banks and credit co-operative

4 Micropolitan statistical areas are defined by the US Office of Management and Budget as labour market and statistical areas centred on an urban area with a population of between 10,000 and 50,000 people.

banks) increase it, and commercial banks have no effect. Increasing the co-operative bank branch density by 10 percent reduces income inequality by 0.2 percent. In contrast, raising the popular bank share by 10 percent increases income inequality by 0.15 percent. With fixed effects, increasing the co-operative bank branch density by 10 percent is associated with a decrease in income inequality by 0.25 to 0.33 percent.

Economic growth

CF-7 (SMS 3, Germany, Italy and Spain) examines the effect of mutual, co-operative, and commercial banks and venture capital investments on regional economic growth. Data on regional economic activity comes from Eurostat, and data on the structure of the regional banking system is from Central Banks. The final sample includes 53 regions in Germany, Italy, and Spain for the period 1995 to 2008. Given regional economic growth can also affect bank credit, the study uses a dynamic panel GMM. Baseline empirical results indicate that a 1 percent increase in total credit supplied by financial institutions is associated with a 0.04 to 0.08 percent increase in regional economic growth (GDP per capita). Mutual and co-operative bank credit is more important in regions whose GDP per capita is in the bottom quartile, while commercial bank credit is more important in all other quartiles.

CF-8 (SMS 3, France) studies the effect of co-operative banks on regional economic growth in France. The study uses a panel data set comprising 88 regional co-operative banks, operating in 26 different regions in the period 2006 to 2012. The data combines financial information on regional co-operative banks from the Bankscope database with regional macroeconomic indicators from the French National Institute for Statistics and Economic Studies, and Eurostat. Using a fixed effects model and four alternative panel specifications (GMM estimators), the study finds assets of co-operative banks as a proportion of regional GDP have a positive effect on regional economic growth. The study suggests two possible interpretations – that this could reflect the market share of co-operative banks in lending to SMEs, or that co-operative banks improve access to finance and promote economic growth. The study also finds that the efficiency of co-operative banks – measured using 'return on total assets of co-operative banks' and 'return on total equity of co-operative banks' – has a positive effect on regional economic growth.

CF-9 (SMS 3, Italy) studies the relationship between a region's financial development (financial depth, efficiency, structure, stability, and inclusion) and economic growth. Financial development is measured by two proxies: financial quality (FQ), a profit efficiency score, calculated using a parametric approach, and financial volume (FV), aggregate bank credit divided by GDP. The study uses data for a group of municipalities (SLL, Sistemi Locali del Lavoro) characterised by geographical proximity, statistical comparability, and common commuting flows of the working population, defined by the Italian Statistical Office in 2005. A panel dataset at the SLL level is constructed by combining bank data on co-operatives and for-profit banks from the BilBank 2000 database (compiled by Associazione Bancaria Italiana), with an SLL data set from the Italian Statistical Office for the period 2001 to 2010. Additional data come from the Bureau Van Dijk's AIDA dataset and the Bank of Italy (Bolletino Statistico). Using a panel fixed effects model, stochastic frontier analysis (SFA), and a GMM estimator, the study finds that co-operative banks have higher FQ compared to other banks over the entire period 2001 to 2010. In addition, it finds a positive relationship between a regional financial development and economic growth (GDP per worker). The effect of FV and FQ are similar in size. When the sample is further disaggregated to compare areas where a bank has a monopoly, FV and FQ have an impact on growth in SLLs where the monopoly bank is a co-operative bank but not in areas where the monopoly bank is another type of bank.

Annex 2: Characteristics of financial institutions

Figure 2.1: Characteristics of financial institutions

Institution	Profit	Ownership	Control	Consumers
Community banks	For-profit	Members	Executive board	Local community
Co-operative banks	For-profit - distributed to members	Members	Members	Members
Credit unions	Non-profit	Members	Members	Members
Mutual banks	For-profit - distributed to members	Members	Executive board	Members
Commercial banks	For-profit	Shareholders or private investors	Executive board	Anyone
Savings banks	For-profit	Shareholders or private investors	Executive board	Anyone

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This work is published by the What Works Centre for Local Economic Growth, which is funded by a grant from the Economic and Social Research Council, the Department for Business and Trade, the Department for Levelling Up, Housing and Communities, and the Department for Transport. The support of the Funders is acknowledged. The views expressed are those of What Works Growth and do not represent the views of the Funders.

May 2024

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