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Financial Services Growth and Competitiveness Strategy Call for Evidence: Positive Money submission

December 2024

Positive Money welcomes the opportunity to respond to the Call for Evidence for HM Treasury's Financial Services Growth and Competitiveness Strategy. Positive Money is a not-for-profit research and campaigning organisation, working towards reform of the money and banking system to support a fair, democratic and sustainable economy. We are funded by trusts, foundations and small donations.

A number of points made in this submission are also echoed in an additional joint response from academics and leaders of other civil society organisations.[1]

Key points

- The government must reconcile its efforts to grow financial services with the wealth of empirical evidence showing that, beyond a certain threshold, the growth of the financial sector harms economic growth. Rather than simply growing the sector itself, the government should focus on ensuring it is able to meet the needs of the real economy, which it is currently failing.
- The government should foster innovation in financial services, especially when there are clear benefits to consumers and society, but should be mindful of the degree to which 'innovative' financial services exploit tax or capital arbitrage, with costs to the wider economy.
- There is a risk that efforts to provide financial services firms with access to a highly skilled workforce will undermine the government's wider strategy, by exacerbating a 'brain drain' effect where the productive R&D-intensive industries the government is attempting to nurture lose the skilled workers they require to financial services, which offer less added economic value to the UK.
- The government should focus on increasing competition within the financial sector rather than its 'competitiveness' with other jurisdictions. Competition is particularly weak in banking and payments, though this could be improved with the introduction of a digital pound and other policy instruments.
- Aligning the entire financial sector with net zero and nature objectives should be a central objective and policy pillar in the strategy, as a siloed approach of growing markets for green and transition finance products without efforts to shift financial flows away from harmful activities, will leave the UK financial system and economy exposed to climate and nature-related risks, and will be insufficient to mobilise capital at the scale needed to meet the UK's broader climate and nature objectives.
- The government should seek to build on its position as a leading international standard setter for green financial policy and regulation, and should not allow deregulation in other jurisdictions to undermine leadership in this area. The Bank of

[1] Joint response by 50 economists and policy experts to Financial Services Growth and Competitiveness Strategy Call for Evidence.

England should seek to re-establish itself as a leader on greening the financial system.

Responses to questions

Question 3.1: Do you agree with the proposed objectives set out in paragraph 3.6?

We do not agree with all of the proposed objectives set out in paragraph 3.6. Below are our comments on objectives we are concerned with.

"supports the start-up and scale up of innovative new types of financial services;"

The government should foster innovation, especially when there are clear benefits to consumers and society. However, the government must stay cognisant of the fact that 'innovative new types of financial services' are often predicated on circumventing existing financial regulation and increasing risk-taking in ways that increase financial fragility and instability. Examples of 'innovation' in financial services include junk bond-financed leverage buyouts, complex securitisation such as the collateralised debt obligations that were at the core of the 2008 crisis, and derivatives which have famously been characterised as "financial weapons of mass destruction". As Gennaioli and Shleifer show, financial innovation can increase financial fragility even in the absence of leverage.

Such 'innovation' can pose wider harms to the economy beyond just financial instability. We share the view of former Financial Services Authority Chair, Lord Adair Turner, who suggests that if financial innovations are driven by either tax or capital arbitrage, then they can be considered 'socially useless' (i.e delivering no economic value at the collective social level) even if they generate private return. Moreover, research by Moritz Schularick and Bank of England Monetary Policy Committee member Alan Taylor finds little support for the claim that financial liberalisation and innovation has led to a corresponding increase in real growth rates.

The government should heed Lord Turner's warning not to "fall into the trap of believing ever more complex innovation is beneficial because it completes more markets, or that an increased aggregate supply of credit is a valid argument in favour of innovation and light regulation."

"provides financial services firms with access to a highly-skilled workforce;"

Efforts to provide financial services firms with access to a highly-skilled workforce risk undermining the government's wider industrial strategy. Research published by the Bank for International Settlements finds that financial sector growth disproportionately harms financially dependent and R&D-intensive industries. As Andrew Haldane put it while Chief Economist at the Bank of England, a "financial vacuum-cleaner effect" hits R&D-intensive businesses (who might otherwise have attracted the scarce, skilled labour that flowed into finance) the hardest, and these are the very industries the government is seeking to re-nurture through its industrial strategy. The government should therefore guard against the risk of the more productive growth-driving sectors identified in its industrial strategy being harmed by a 'brain drain' of highly-skilled workers towards financial services that offer less added economic value to the UK.

has sustainable growth in the financial services sector across all regions and nations;

The government would need to clarify what 'sustainable growth' in the financial services sector looks like. There is a wealth of empirical evidence showing that, beyond a certain threshold, there is a negative relationship between financial sector growth and the growth of the wider economy. Studies published by the IMF and BIS have found that more finance has a negative effect on output growth when credit to the private sector reaches 100% of GDP. As of 2023, credit to the private sector averaged 160 percent of UK GDP since 2000. While there is some contestation in the literature, the pattern is clear: as a 2021 research study put it, "too much finance is robustly found to harm growth."

Rather than growing the size of the financial services sector, the objective should be to ensure the sector is able to support the wider economy and sustainable prosperity across all parts of the UK. Our analysis of the most recent Bank of England money & credit data suggests the UK financial system is currently unable to meet these goals. The stock of loans held by non-financial corporations is lower than it was in 2010, falling around half in real terms. Net lending to productive industries has been negative for the past three years. Without taking steps to shape its allocation of credit, simply seeking to grow the size of the financial sector will likely only worsen this dynamic.

'continues to be a world leading sustainable finance centre and the global destination of choice for firms to raise green capital'

We agree that sustainable finance should be a key objective of a strategy for the financial sector, and is an opportunity for the UK to build on its current strengths. However, what constitutes a 'world-leading' sustainable finance centre should be considered according to the greenness (according to both the sector's impact on the environment and its support for the green transition) of the entire sector, rather than solely in terms of the size and competitiveness of UK markets for green or sustainable finance products. An approach focused on the latter would risk the UK's financial sector facilitating the continued financing of activities that undermine domestic and international climate and environmental goals. Ultimately, the entire financial system must be aligned with and support efforts to green the real economy. We would urge that this be clearly reflected in the strategy's objectives, such as through additional phrasing: 'continues to be a world leading sustainable finance centre and the global destination of choice for firms to raise green capital by aligning the financial sector with domestic and internationally agreed net zero and nature goals'.

Relatedly, robust policy and regulation should be considered as a key indicator of progress on this objective, given that respondents to the 2024 GGFI survey, which informs the ranking, highlighted Risk Management Frameworks, Policy and Regulatory Frameworks, and International Initiatives; as the most important drivers of green finance. The UK was an early leader in this area, setting an ambition in 2021 for London to become the world's first Net Zero-aligned financial centre, and developing key regulatory initiatives such as the Transition Plan Taskforce, but it risks falling behind if momentum is lost. Many commitments made in the 2023 Green Finance Strategy have been subject to delay and are still yet to be delivered, notably the UK Green Taxonomy, transition plan requirements, and tracking of green financial flows.

Stalling progress on aligning monetary and prudential policy with net zero and environmental objectives is particularly undermining the UK's sustainable finance leadership position, as well as impacting the UK's ability to achieve broader climate, environmental, and clean energy goals. Despite emerging as an early leader amongst central banks in its approach to greening its own asset purchases, the Bank of England has recently reduced its resourcing of climate work and narrowed its areas of focus, notably removing emphasis on, 'Supporting an orderly economy-wide transition to net zero', and 'Working towards a timely and coordinated international approach to climate change'. We would urge that the Bank of England's progress in this area, measured for instance by its ranking in comparison to international peers, be considered a key marker of success.

Question 3.3: What do you consider to be the most important trends or changes likely to affect the financial services industry over the next 10 years?

The most important trends or changes likely to affect the financial services industry over the next 10 years include the growth of market-based finance and increased 'disintermediation' of the banking sector, as well as climate and nature risks, and the green transition.

<u>Growth of market-based finance and 'disintermediation'</u>

Non-bank financial institutions (NBFIs) are playing an increasingly important role in the financial system, with nearly all of the increase in net borrowing by UK business since the global financial crisis coming from market-based sources rather than direct bank lending, and market-based lending now accounting for 56% of UK corporate debt.

This 'disintermediation' of the banking sector could be exacerbated by the emergence of new forms of money, such as central bank digital currencies or privately-issued stablecoins, which may outcompete bank deposits as a means of payment. As Andrew Haldane suggested while Bank of England Chief Economist, this "radically different topology … would reduce at source the fragilities in the banking model that have been causing financial crises for over 800 years", and that "Given the costs of these crises – large and rising – this is a benefit that needs to be weighed."

With the growth of market-based finance and greater disintermediation, central banks may be required to provide greater liquidity to banks, as well as the wider financial sector, as reflected in the Bank of England's extension of facilities to NBFIs. The shift to market-based finance may disfavour SMEs, who are constrained in their ability to raise funds by issuing bonds and shares, and typically rely more on direct bank lending. Further credit market interventions, in the vein of the Term Funding Scheme with additional incentives for SMEs may be required.

Policymakers will need to devise a regime that minimises the threat of regulatory arbitrage between banks and non-banks, in which the risk banking regulations like Basel have sought to contain with higher capital requirements, shift to shadow money issuers in the non-bank sector. One approach could be to require that all financial institutions fully back the short-term liabilities they issue with pre-positioned collateral, as suggested by former Bank of England deputy governor Sir Paul Tucker.

<u>Climate and nature risks and the green transition</u>

The climate and nature crises, as well as the impacts of the transition to a net zero and nature-positive economy and the need to shift financial flows to enable this, are significant trends that are already impacting the sector and will exacerbate over the next 10 years and beyond. These trends impact the financial sector through several complex channels. The physical impacts of climate change and nature degradation, as well as the impacts of the transition to a net zero and nature-positive economy, could impact financial asset values with significant impacts on individual firms' balance sheets. Severe, acute physical impacts, or a poorly coordinated green transition, could trigger disorderly repricing and a climate 'Minsky moment', and as such should be considered as a systemic risk.

UK policy and regulation is not currently sufficient to protect against these risks, nor is it creating adequate incentives to shift financial flows in line with net zero and nature goals. Thus far, efforts have focussed on increasing firms' understanding of the likely impacts of climate change and nature loss to their balance sheets, with the aim that these risks are incorporated into market pricing (key examples being TCFD and TNFD regimes). However, accurately estimating such impacts is an extremely difficult task, due to the uncertainties and non-linear dynamics of environmental change and its impacts on a highly interconnected financial and economic system. Efforts are being made to improve both scenario analyses and firm-level risk models, and the Network for Greening the Financial System (NGFS), whose scenarios form the basis of many of the models used by individual firms to inform their own climate-related risk management, recently updated their scenarios, increasing their estimates of GDP losses by two to four times compared to previous estimates, now estimating 15% global GDP losses by 2050 under current policies. Whilst these figures are significant, key factors are still omitted, including the absence of climate tipping-point dynamics, impacts of nature degradation, compounding risk dynamics and socioeconomic effects such as migration or conflict, and many market actors are not using the latest available approaches. As a result, research has shown that modelling limitations result in financial market actors finding startlingly limited impacts of climate-related risks on their portfolios, with the result that such exercises and disclosure regimes are not adequately driving changes in capital allocation.

Meanwhile, the physical impacts of climate change and nature loss are accelerating at pace, and governments, including the UK, are setting ambitious climate, nature, and clean energy transition objectives. To ensure the resilience of the financial system, it is critical that governments and financial supervisors move beyond disclosure-based regimes and do not wait for risk models to 'catch up'. Instead, they must adopt a 'precautionary approach' to climate-related financial risks, meaning swift and coordinated action to shift capital allocation away from risk-driving activities and to ensure financial institutions are adequately capitalised in the event that risks crystallise. It is also urgent that adaptation efforts are accelerated to increase the resilience of the wider economy and financial sector to damages to property and infrastructure, which are already occurring and will have knock-on impacts for financial asset and collateral values.

Question 4.1: Do you agree with the list of policy pillars that the government intends to focus on? Are there other areas that should be included?

Aligning the financial sector with net zero and nature objectives should be included as an additional policy pillar. As outlined in response to Q.3.3, the climate and nature crises pose severe threats to financial and economic stability, and ensuring the sector supports government efforts to achieve these goals is necessary to mitigate these risks and enable a green transition.

Question 4.3: How well is competition currently working in the financial services sector, and how can it be improved?

Competition is weak in the UK financial services sector. The banking and payments sectors are particularly uncompetitive. As of April 2024, the UK's four largest banks control 75% of personal current accounts and 85% of business accounts. The current bank-based payment system suffers from high degrees of market concentration, which allows payment providers to charge merchants inflated fees (with charges for SMEs particularly excessive), which are then passed on to consumers in the form of higher prices.

There are significant barriers to entry for firms seeking to innovate and compete with incumbents, and new entrants to the retail banking market have therefore been relatively rare. Obtaining a banking licence remains costly and regulation has tended to favour large incumbents.

The exclusivity of access to central bank infrastructure, including reserve accounts, particularly disadvantages smaller financial firms, limiting their ability to offer current accounts and payment services. Without going through the costly process of obtaining a full banking licence, new entrants are unable to compete with incumbents and instead must rely on the large clearing banks to settle payments through their central bank reserve accounts, for which they are charged fees that can be many times higher than the actual cost to the bank.

A digital pound offers an opportunity to improve competition, by enabling new entrants to provide payment accounts and services without being dependent on access to the balance sheet of commercial banks. By opening up its balance sheet to a wider range of financial and technology firms through a CBDC, the Bank of England could provide a new foundation for innovation in the sector: challenger banks, fintechs and purpose-led financial organisations could compete on a more even footing with the large incumbent banks.

Other policy levers could also foster greater competition in the financial sector. For instance, lending schemes, such as the Term Funding Scheme, as well as new initiatives such as the National Wealth Fund, could be enhanced to provide more sustainable funding for smaller banks, as well as Community Development Financial Institutions (CDFIs) and other stakeholder lenders, allowing them to scale-up and compete with large incumbents who have easier access to cheaper funding through capital markets.

Question 4.5: Which technologies do you think have the most potential to transform financial services over the next 10 years? And in which financial services sectors or functions do you see these being applied most effectively?

Innovations in cryptography and secured hardware offer opportunities for transformation by enabling genuinely peer-to-peer digital payments, which has the potential to significantly reduce costs while increasing functionality and resilience.

Question 4.6: What is your assessment of the UK's current regulatory environment?

Our assessment is that the UK's current regulatory environment is weak, and the implementation of regulation, such as Basel, incentivises high-collateral unproductive lending, such as mortgages, rather than investment in the real economy, with severe consequences for the UK's economic performance. A large volume of academic literature has studied this relationship between the growth of mortgage credit and weaker economic performance, and ultimately financial instability. Attempts to increase the 'competitiveness' of the sector by further loosening regulation risks worsening this trend.

Question 4.9: How can we capitalise on synergies between different regional financial services hubs to support growth?

The new National Wealth Fund (NWF) offers an opportunity to grow regional finance hubs. If the NWF is empowered to act as a true development bank, it could extend regional branches, working with stakeholder banks and devolved authorities, to support regional and local growth plans. As Andrew Haldane remarked while Chief Economist of the Bank of England, "the scale and scope created by a Development Bank is necessary to reach SME start-ups and scale-ups across all sectors and all regions."

Question 4.11: What is your assessment of the UK's ability to effectively upskill and reskill domestic workers for roles in the financial services sector?

As discussed in our response to question 3.1, upskilling and reskilling domestic workers for roles in the financial services sector would likely harm the other sectors the government is trying to grow through its industrial strategy, which will be competing for skilled workers. These more productive and R&D intensive sectors have the potential to offer greater added value to the UK economy, and should be prioritised, and thus protected from the 'vacuum cleaner effect' of a growing financial services sector.

Question 5.3: What do you see as the most important ingredients for a thriving UK fintech sector in the coming 10 years?

The most important ingredients for a thriving UK fintech sector is public digital infrastructure for private firms to build and innovate on, and strong regulation to ensure trust.

We share the Bank of England's view that a CBDC could provide a public platform for retail innovation, and believe that it could inject healthy competition in money and payments in a similar manner to how public institutions, such as the Girobank, previously drove competition and innovation in retail financial services.

There is a risk that poorly regulated products may undermine the success of the fintech industry. This is particularly a risk in respect to crypto-assets. Stronger regulation of crypto-assets, including stablecoins, is required to ensure trust in the fintech sector, as well as trust in money itself.

Question 5.5: In the UK's sustainable finance framework, as set out in the Chancellor's Mansion House package, do you see barriers or gaps that would support the growth and competitiveness of the UK sustainable finance market?

As outlined in response to question 3.1, a world leading sustainable finance centre should be assessed according to the activities of the entire sector, and the sector's support for net-zero and environmental objectives. The sustainable finance framework, as set out in the Mansion House package, is not yet comprehensive enough to protect the financial system from systemic climate and environmental risks, and to ensure the sector contributes to the government's climate, environmental, and clean energy objectives.

The government's manifesto pledge to introduce mandatory 1.5C aligned transition plans for financial institutions is a welcome improvement on the previous government's 'comply or explain' approach. We would urge the government to reassert its commitment to this pledge, and set out a clear roadmap for the introduction of 1.5C aligned transition plans, to place the UK in a leadership position in this area and ensure that transition plans materially contribute to aligning the sector with the government's objectives, rather than becoming simply another disclosure or tick box exercise that does not drive behaviour change.

Crucially lacking from the sustainable finance framework is a plan to align monetary and prudential policy in support of the green transition. Central banks globally are outpacing the UK in this area, in recognition that this is necessary to meet both their primary objectives of financial and monetary stability, and secondary objectives to support government policies. In reducing its resourcing of climate work and narrowing its focus areas, the Bank of England – whose leadership previously positioned the UK as an early mover on green finance – is now falling behind internationally. Though the emphasis on climate change and nature loss in the MPC, FPC, and PRC remit letters is welcome, we would urge the Treasury to work with the Bank to ensure that a cohesive package of policies is brought forward.

Question 5.6: What do you think should be the UK's priority when engaging with the global sustainable finance agenda, both bilaterally and at a multilateral level?

The UK should use its role in international political, multilateral, and supervisory fora to advocate for internationally standardised and ambitious policy and regulation. However, whilst international standardisation is optimal, as Chair of the FCA Ashley Adler recently highlighted to the Treasury Select Committee, there is a trade-off between the government's objective for the UK to be a world-leader in setting regulatory standards, and the drive for international competitiveness in a context where other jurisdictions are pursuing financial deregulation. The UK must not be drawn into a race to the bottom in deregulation if other jurisdictions lag behind. The UK should instead seek to act as a standard setter for others to follow, a key opportunity for which is to become a world-leader by implementing 1.5C-aligned transition plans for financial institutions, learning from mistakes made in the EU and developing a science-based green taxonomy, and expanding the UK's ban on public finance for new fossil fuel projects overseas to UK-based private financial institutions, who play a significant role in the world's ability to meet climate and environmental targets versus the broader UK economy.

The UK should also use its role to promote the reform of the international financial system, which currently is a structural barrier to just transitions globally. The UK should meaningfully engage with governments of climate-vulnerable countries and advocate for climate finance for Global South countries to be urgently scaled up, and done so in a way that does not exacerbate existing global inequalities and debt crises and thus further constrain the fiscal space of Global South countries to transition their economies. This means scaling up grant-based forms of finance rather than relying on private sources that reinforce existing debt dynamics, as well as supporting comprehensive debt cancellation, reallocating Special Drawing Rights (SDRs) from wealthier countries to Global South Countries, and reforming SDR's into a vehicle for long-term financing for climate and sustainable development priorities. The UK should also support the development of new cross-border and regional payment systems that could strengthen the financial resilience of Global South countries and support greater economic policy space for green transitions.

Question 5.7: What are the opportunities and barriers for the financial services sector in developing the products and/or services necessary to facilitate investment into the net zero transition?

The financial services sector will only facilitate investment into the net zero transition to the extent that opportunities are available and match the risk-return profile of financial institutions. High interest rates remain a key barrier to investment in the clean energy sector, as clean energy projects are highly capital intensive and often incur almost all costs upfront, with firms typically more highly geared than fossil fuel incumbents. This contrasts strongly with the oil and gas sector, which is less sensitive to rate rises due to being comparatively cash rich and less reliant on debt financing. Despite this, oil and gas companies are failing to transition their business models. A key intervention to reduce this disadvantage, which would have the effect of increasing the finance sector's support of the transition, is repurposing the Bank of England's existing Term Funding Scheme (TFS) to pass through lower interest rates for clean energy companies. The TFS offers cheap funding to commercial banks, provided that they demonstrate they have expanded lending to households and businesses. The most recent iteration also offered additional incentives for SMEs (TFSME), developed through coordination between the Treasury and the Bank of England. This scheme could be adapted to offer cheaper funding to clean energy sectors, supporting investment as well as meeting the Bank of England's mandate for price and financial stability by reducing risk of fossil-fuel price shocks and reducing future economic and financial risks induced by climate impacts.

As well as such measures to incentivise clean investments, measures are needed to disincentivise investments into activities that must be phased out to meet climate and nature goals – namely fossil fuel expansion, in line with the International Energy Agency's net zero pathway, and deforestation, in line with the global commitment made at COP26. Such tools include the adjustments of central bank collateral frameworks and making adjustments to the capital framework, both of which would also support wider system resilience as outlined in response to question 3.3.

For more information on this response or any of Positive Money's wider work, please contact Simon Youel at simon.youel@positivemoney.org.uk.