Financial regulation and competitiveness

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We do not regard any of the information in our submission as confidential.

1. Introduction.

We welcome the consultation on how the Prudential Regulation Authority intends to approach policy-making as it takes on wider rulemaking responsibilities under the Financial Services and Markets Bill, and as the United Kingdom and its financial sector adjust to life outside the European Union.

Financial services are of fundamental importance to any economy, but especially important to the UK economy, which has a larger and more dominant financial services sector than most. However, this outsized role for finance in the UK economy comes with outsized political and economic influence for the finance sector, as has been extensively documented elsewhere: and the regulators are partly funded by the very industry it regulates[1]. We therefore begin by noting that there are strong risks that financial sector policy, regulation and enforcement will tend to be set up and operationalised in ways that favour the financial sector, irrespective of whether it benefits the wider British economy.

This submission will provide evidence that not only are the interests of the financial sector (of course) not identical to the interests of the wider UK economy, society, democracy or national security – but that there are important instances where the interests of important parts of the financial sector conflict with the PRA's focus on financial stability – and with other regulatory objectives, and with the wider interests of the British people. This lesson was made abundantly clear by the last global financial crisis, but memories are fading and it appears that some of these crucial lessons are being forgotten. As the PRA grows into its new post-Brexit role, we urge it to re-embed those lessons firmly and explicitly into every aspect of its thinking, rulemaking, planning, and operations.

This submission will provide evidence and analysis in two main areas.

First, we will review the extensive (if contested) international evidence that "too much finance" can harm economic growth and other aspects of wellbeing, note important new evidence and research, and discuss where more research is needed. We will also, at a more microeconomic level, present examples of how certain parts of the UK financial sector have inflicted harm on the UK economy, to illustrate the issues.

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[1] For example, a recent report by the Treasury select committee said: "We will remain alert for any evidence that regulators are coming under undue pressure from the Treasury to inappropriately weaken regulatory standards." See [House of Commons Treasury Committee Future of financial services regulation: First Report of Session 2022–23](), June 13, 2022, p.3. Baker, A. (2010). Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance. *International Affairs*, *86*(3), 647-663. Baker, A., & Wigan, D. (2017). Constructing and contesting City of London power: NGOs and the emergence of noisier financial politics. *Economy and Society*, *46*(2), 185-210.Young, K. L., & Pagliari, S. (2022). Lobbying to the rhythm of Wall Street? Explaining the political advocacy of non-financial corporations over financial regulatory policy. *Socio-Economic Review*, *20*(2), 659-685. For funding of the regulators, see e.g. https://www.bankofengland.co.uk/about/governance-and-funding

Second, we will examine and analyse a new competitiveness objective described in [Discussion Paper DP4 / 22](#) ("DP 4/22"), to which this submission is responding, and link it to the evidence related to "Too Much Finance".

We will show that competitiveness is a confused, unclear and dangerous objective, and likely conflicts with several other government (and PRA) objectives, such as supporting economic growth, or promoting healthy competition in private markets. Given that the (secondary) competitiveness objective for finance now appears to be a politically settled matter, however, we will offer some thoughts on how to interpret the objective and minimise the many threats that it poses.

2. Too Much Finance?

The Great Financial Crisis of 2007-2009, the near meltdown associated with the Covid Pandemic in March 2020, and the ongoing crash of Crypto related assets, have all provided plenty of evidence that insufficiently regulated finance can lead to bouts of financial instability that can spill over into wider economic distress. In addition, a growing body of economic research has suggested that the negative impacts of "excessive" or "unproductive" finance can, in addition, lead to a slowdown in longer term economic growth, even on top of the impact that risky financial activity might have on financial instability and financial crises. This is known as the "Too Much Finance" (TMF) problem, named after one of the first and most influential of the articles published about the subject.[2] Hence there may be at least two kinds of economic problems associated with large amounts of risky and even unproductive financial activity: a propensity to generate financial instability and crises that have large economic and social costs; and an additional drag on economy wide productivity and economic growth.[3]

The empirical literature identifying the widespread economic costs of financial crises is well established. For example, Taylor, et. al and Jorda, etc. have shown using long historical data sets and sophisticated econometric analysis that economic crises associated with financial crises are, on average, deeper and longer lasting than crises caused by other factors, such as oil price shocks.[4] BIS economists have also shown that expansions fueled by excessive credit booms have a high likelihood in ending in a recession and decline in productivity growth[5].

All this literature points to the need for strong preventative financial regulation to limit excessive private credit expansion and excessive risky financial activities.

But the "Too Much Finance" literature indicates that even apart from financial activity that leads to financial crises, financial sectors that are "too large" relative to the size of their economies, appear to be associated with lower overall productivity growth and growth in GDP. The classic papers in the TMF literature use a variety of data sets and econometric

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[2] Arcand, J.L., Berkes, E. & Panizza, U. (2015). Too much Finance?. *J Econ Growth* **20**, 105–148. https://doi.org/10.1007/s10887-015-9115-2

[3] Cecchetti, S., Kharroubi, E. (2012). Reassessing the Impact of Finance on Growth. BIS Working Paper 381.

[4] Sufi, Amir and Alan M. Taylor. (2021). "Financial Crises: A Survey", NBER Working Paper, No. 29155. https://www.nber.org/papers/w29155 . Reinhart, Carmen and Kenneth Rogoff. 2014. "Recovery from Financial Crises: Evidence from 100 Episodes". American Economic Review. 104(5): 50-55.

[5] Borio, C. (2014) "The Financial Cycle and Macroeconomics: What Have We Learnt?" Journal of Banking and Finance 45 (August): 182–98. Also available as BIS Working Paper No. 395 (December 2012).

techniques that indicate that the relationship between the size of a country's financial sector, (usually measured as the amount of private credit issued relative to GDP) and the overall rate of economic growth is inverted U (or mound) shaped: up to a certain level of private credit share, more private credit is associated with higher rates of economic (or productivity) growth. However, at a certain point of private credit share, the association turns negative: more private credit is associated with lower GDP or productivity growth. The turning point (or "optimal size") for private credit's impact on growth was somewhere between 90% and 120% of GDP. The United States and the UK, among other countries, were far above that.

These findings contrast sharply with previous standards, many of them carried out by Levine and colleagues, which appeared to find a linear positive relationship between the amount of private credit (as a share of GDP) and the rate of economic growth.[6]

Apart from possible issues with measurement and econometric methods (discussed below), the major questions posed by these findings related to what can explain them and what do they mean? A core explanation for the negative relation between (the large) size of the financial sector and economic growth is that the sector "soaks up" large amounts of talented employees who would otherwise be employed in other, more productive, sectors.[7] Economist Christiane Kneer from De Nederlandsche Bank has provided the most compelling empirical research showing this effect. She shows that in the cases of 13 countries observed over the period 1980-2005, financial liberalisation is associated with skill upgrading in the financial sector. She then analyzes the impact on skill levels in manufacturing sectors of these economies. She shows that financial liberalisation is at the same time associated with decreases in labour productivity, total factor productivity and value added in non-financial industries that rely heavily on skilled labour. Kneer concludes that "This is consistent with the idea that financial liberalization hurts non-financial sectors via a brain-drain effect".[8]

Implicit in this argument is the condition that at least some parts of the financial sector are able to pay higher wages that would attract skilled workers from other sectors, despite the fact that they might be, at the margin, less productive than those in other sectors, an assumption that is borne out in the data.[9] A complementary explanation is that these large financial sectors are allocating fewer relative funds to manufacturing and more to non-manufacturing sectors such as real estate.[10] These sorts of arguments are consistent with other research identifying the pull of the so-called "best and brightest" into finance.

This explanation for the finding of too much finance suggests that the "excessive size" of the financial sector, combined with an ability to pay high salaries despite being less productive

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[6] Levine, R., 2005. Finance and growth: theory and evidence. In: Handbook of Economic Growth. Elsevier, Amsterdam, pp. 865–934; Beck, T., Levine, R., Loayza, N., (2000). Finance and the sources of growth. J. Financial Economics. 58, 261–300. https://doi.org/10.1016/S0304-405X(00)00072-6

[7] James Tobin, the Nobel Prize winning economist wrote in 1984, even before financial sectors had grown to such large proportions: "I confess to an uneasy Physiocratic suspicion, perhaps unbecoming in an academic, that we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity." Tobin, James. (1984). "On the efficiency of the financial system". Lloyds Bank Review, 153, pp. 1 – 15.

[8] Kneer, Christiane. (2013). "Finance as a Magnet for the Best and Brightest: Implications for the Real Economy". DNB Working Paper, No. 391. September

[9] Philippon, Thomas and Reshef,A. (2012). "Wages and Human Capital In The U.S. Finance Industry: 1909–2006", The Quarterly Journal of Economics, Vol. 127 November, Issue 4.

[10] Bezemer, D. Ryan-Collins, J., van Lerven, F., and Zhang, L. (2021). "Credit policy and 'debt shift' in Advanced Economies". *Socio-Economic Review*. *https://doi.org/10.1093/ser/mwab041*

(at the margin) implies that it is not just the size of the financial sector, but also the nature of activity in the financial sector that generates lower economic growth. It suggests that certain kinds of financial structures and behaviours are able to extract high returns, without commensurate contributions (or with negative contributions) to productivity growth. It is not just what finance is, but also what finance does, that is at issue here.

2.1 Measurement issues

Most of the empirical research that has found the "Too Much Finance" effect has used cross sectional or cross-sectional – time series data methods. These methods have been criticised for a number of short-comings, but have proven to be robust to most of these critiques.[11]

The main criticism that has stuck is the claim that these methods are not able to truly pin down "cause and effect"[12]. The ability to prove causation is notoriously difficult in economics and especially in macroeconomics where is nearly impossible to perform "controlled experiments". In response, econometricians have tried to develop econometric techniques that simulate controlled experiments, but such techniques are only as good as the data that history and nature provide. To identify "causation" these these techniques normally require long data series which provide the ability to tease out causal relationships. But the problem with macroeconomics and especially macroeconomics regarding finance, is that the underlying financial system is rapidly evolving. So it is very difficult to get long time series from a stable economic structure: in other words, too many things are all changing at once. So, for example, Cho, Desbodes and Eberhardt (2022) use sophisticated econometric techniques and "find" that they cannot identify a statistically significant relationship between high levels of private credit creation and lower economic growth when they disaggregate the data in various ways to study cause and effect. But it is likely that the reason for their failure to find the TMF result is that they simply do not have enough data to tease out a strong statistical relationship – to separate the signal from the noise.

This is not to say that the "Too Much Finance" literature has *proven without a doubt* that there is causation between the size and nature of financial activities and lower productivity and economic growth. Such definitive proof is rare to non-existent in the field of economics. But the evidence the literature has provided, in combination with other complementary evidence mentioned earlier, makes a sufficiently strong case for TMF, that one article with mostly insignificant statistical results cannot reasonably be assumed to cancel it out.

In short, the too much finance literature has amassed a large amount of statistical, descriptive and anecdotal evidence to very plausibly suggest that financial sectors that are very large relative to the size of their economies not only contribute to financial instability and even crises, but also to misallocation of labour and other resources that make it more likely that the economy will experience lower productivity and economic growth overall.

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[11] See for example, Sturn S., Epstein, G. (2021). "How much should we trust five-year averaging to purge business cycle effects? A reassessment of the finance-growth and capital accumulation-unemployment nexus". "Economic Modelling", 96. 242-256.

[12] Cho, R., Desbordes, R., and Eberhardt, M. (2022), "Little Evidence for Too Much Finance", VoxEU, March. https://cepr.org/voxeu/columns/little-evidence-too-much-finance . Cho, R., Desbordes, R., and Eberhardt, M. (2022), "The Causal Effects of the Darker Side of Financial Development", June. https://lezme.github.io/markuseberhardt/darker_side.pdf

2.2 Competitiveness and "Too Much Finance"?

Given this evidence it is worth asking what the linkages might be between the likely TMF effects, discussed in this Section 2, and 'competitiveness', as discussed elsewhere in this document?

It would be uncontroversial to say that the financial sector contains clearly healthy and beneficial activities (such as bank lending to help healthy SMEs invest and expand) as well as clearly harmful activities, (such as bank lending to a monopolist to facilitate predatory pricing to drive out competitors) – with a substantial grey area in between the healthy and the harmful. Causation in any overall TMF effect would clearly lie in the 'harmful' parts. Estimates of the economic costs of TMF to the U.K. economy are very substantial indeed[13].

We would argue that policies to promote 'competitiveness' would tend to promote these harmful aspects, while also undermining the healthy parts, for all the reasons explained elsewhere in this document. In addition, as discussed below, finance plays two roles in the UK economy: i) in facilitating and supporting other areas of the UK economy (beneficial roles); and ii) as a profit centre in its own right, and as a source of financial services export revenues. As discussed below, "competitiveness" relates only to the second, "profit centre" aspect, and that is also where (by definition) the harmful activities will tend to lie.[14]

3. The trouble with competitiveness

In May, we co-signed a letter by over 50 economists from around the world ("the Economists' Letter"), including some of the most prominent names in the field, arguing that a "competitiveness" objective would be incoherent and dangerous for the UK. Subsequently, a report by the Treasury Select Committee, citing this letter, warned that:

> "We recommend that there should be a secondary objective for both the Financial Conduct Authority and the Prudential Regulation Authority to promote long-term economic growth. The wording will be crucial: pursuing international competitiveness in the short term is unlikely to lead to economic growth or international competitiveness in the long term if it is achieved by weakening the UK's strong regulatory standards.

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[13] Other harmful aspects include broader misallocation costs (the price of diverting resources away from non-financial activities and into finance through lost productivity or lower investment of skills and capital in R&D intensive areas in particular, including the "brain drain" discussed above;) as well as finance-related 'value extraction' from non-financial parts of the economy; and higher inequality and corrosive social and political effects. The UK's Finance Curse? Costs and Processes. Andrew Baker, Gerald Epstein, Juan Montecino, Sheffield Political Economy Research Institute (SPERI,) Oct 2018.

[14] For example, Martin Wolf states that the reasons for the emergence of widespread risk-taking ahead of the last crisis were partly a belief that "it is different this time," but also in the UK's case, "the belief that banking is a profit centre for the economy. And so, it was concluded, the country's finance must be kept "competitive" by "light-touch" regulation." See *Competitiveness' mantra must not let risky banking rise again*, Martin Wolf, Financial Times, Dec 2, 2022. Also, Baker, Epstein and Montecino (2018, ibid.) in their estimates of the cost of TMF to the UK state that "The data suggests that the UK economy, may have performed much better in overall growth terms if: (a) its financial sector was smaller; (b) if finance was more focused on supporting other areas of the economy, rather than trying to act as a source of wealth generation (extraction) in its own right."

We will shortly summarise in brief the reasons given in the economists' letter why competitiveness is such a problematic regulatory objective. Before doing that, however, it is essential to clear up an initial potential area of profound confusion: between a *competitiveness* objective, on the one hand, and a *competition* objective, on the other. The Discussion paper DP 4/22 notes:

> "The FSM Bill introduces an additional secondary objective to facilitate, subject to alignment with international standards, the international **competitiveness** of the UK economy and its growth in the medium to long-term. Given the anticipated expansion in the PRA's role, we will approach this new secondary objective in a fully engaged and proactive manner – as we have done for our current secondary **competition** objective." [Our emphasis added.]

John Kay recently summarised briefly this difference between the new competitiveness objective and the older competition objective:

> "Competitiveness should be carefully distinguished from competition: competition to offer British consumers and businesses better value for money is something we should all want; pursuing "competitiveness" as a regulatory objective means using regulation to attract activity to London from other financial service centres, something of benefit only to those who work in the industry, as we have learned to our cost already."

We would add that the linguistic similarly of the two c-words often results in a "halo effect" being transferred from the "good" c-word (competition) to the "problematic" c-word (competitiveness), lending competitiveness an undeserved credibility, certainly in the minds of many people who have not taken time to think deeply about the issues.

3.1 Economists' Letter

The Economists' Letter, strongly opposing any competitiveness objective at all, laid out a number of reasons why "competitiveness" was not only hard to define and a confused concept in itself - but also dangerous for the UK and its people.

i) After the last Global Financial Crisis, it became widely accepted in regulatory circles that a competitiveness objective had contributed greatly to the calamity. Competitieness had been achieved essentially by weakening standards to attract international finance activity. Andrew Bailey, Bank of England Governor, said we tried a competitiveness objective before, and "it didn't end well, for anyone."

ii) The primary role of the financial sector is to support the economy as an intermediary and facilitator of economic activity. It can also be a source of export earnings, but this subsidiary role should not undermine the primary role. A competitiveness objective speaks only to the subsidiary role.

iii) Financial actors and parts of the financial sector compete *against* other parts of the UK economy and society: for example, in terms of inputs, with high pay in finance pulling talented people and resources out of other economic sectors. Likewise, weakening oversight to prioritise financial inflows from Russian oligarchs harmed Britain's national security.

iv) A "competitiveness" objective is concerned with boosting the UK financial sector, under an unstated assumption that "more finance," or a wealthier or larger UK financial sector, means a healthier UK economy. But the international evidence,

summarised in Section 2 above, shows that "too much finance" likely reduces UK prosperity and wellbeing overall, also with corrosive political effects.

v) "Competitiveness" in financial regulation considers regulation in relation to other countries or financial sectors. One could imagine a "good" version which prioritises safety, probity or competitively lower fees – all adequately covered by existing objectives – or a "bad" version such as via weakening money laundering rules to attract dirty money, or via relaxing rules to allow firms to take profitable risks at taxpayers' expense. (In reality, it is very hard to uphold clear distinctions between the two[15].)

vi) The (current iteration of the) objective is ill-defined and confused (See Section 4 below.)

The Economists' Letter added, reasonably, that the UK financial sector already has extensive political support in the UK and does not need regulators, tasked with the safety, soundness, resilience and usefulness of the UK financial system and economy, to be roped in as additional cheerleaders – especially if this cheerleading role undermines those other essential tasks.

We would add that since this letter was published, several heavyweight former regulators or economists, including Martin Wolf, Howard Davies, and John Vickers, have added further specific and general warnings about the dangers of this competitiveness objective.[16]

4. Navigating competitiveness confusions

It appears that the government has settled for a secondary competitiveness objective for the PRA. We still urge a change of policy and the complete removal of this objective, but in the absence of such a change it is important that the concept is interpreted, implemented and operationalised in ways that minimise the potential harm.
We note, at the outset, a considerable lack of clarity between government departments and regulators, including the PRA, over what this secondary objective means.

For example, in announcing the objective on July 20th, 2022, HM Treasury stated:

> "Legislation to enhance the **competitiveness of UK financial services** and unlock growth and investment across the UK was introduced to Parliament today."

[15] For example, see *Border Problems,* Charles A.E. Goodhart and Rosa M. Lastra, Journal of International Economic Law, Volume 13, Issue 3, September 2010, Pages 705–718.

[16] **Martin Wolf**, the Financial Times' chief economics commentator, and a former member of the Independent Commission on Banking, published an an article focusing heavily on bank safety. He added an important further point: "the idea of promoting competitiveness by relaxing regulation is perilous. The risks will emerge slowly: Sunak and the rest of his government will be long gone. But the mantra of "competitiveness" will start the journey down a dangerously slippery slope." See *'Competitiveness' mantra must not let risky banking rise again,* Martin Wolf, Financial Times, Dec 2, 2022. **Howard Davies**, the chairman of NatWest and a former head of the Financial Services Authority, opposed the proposed competitiveness clause and added that, as reported in The Guardian, that this: "went further than the guidance laid out prior to the financial crisis. At that time, he said the FSA only had to prove that issues such as competitiveness were "taken into account" and were not something "you were trying to achieve directly". (See *Mini-budget an 'international embarrassment' says NatWest boss*, The Guardian, Dec 6, 2022.) **John Vickers**, Former Chair of the Independent Commission on Banking, warned that the "competitiveness and growth" objective is "either pointless or dangerous." See Letter: The City should not receive special favours, John Vickers, Dec 7, 2022.

This would suggest that the objective concerns the "competitiveness of UK financial services." However, the discussion paper DP 4/22 describes (p4) a secondary objective to facilitate "**the international competitiveness of the UK economy** and its growth in the medium to long-term."

Which is it? The international competitiveness of UK financial services – or the international competitiveness of the UK economy? They are of course not identical. On this crucial question, it is worth quoting the Economists' Letter in a little more length:

> "It is necessary to distinguish between the competitiveness of a private company, and the competitiveness of a whole country. It is meaningful to talk of a company being competitive, but economists know that it is hard to pin down how whole countries might compete in economic terms. For example, uncompetitive companies (like Northern Rock) can collapse and disappear, while uncompetitive countries may perform poorly, but they don't disappear. The processes are completely different.
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> In a famous 1994 *article Competitiveness: A Dangerous Obsession*, the US economist Paul Krugman warned that "a government wedded to the ideology of competitiveness is as unlikely to make good economic policy as a government committed to creationism is to make good science policy." [17]
>
> It is worth asking which version of competitiveness the FRF envisages. Is it the private-company version, or the whole-country one?
>
> The FRF does not adequately define "competitiveness," although recent high-level official statements suggest that it involves two overlapping objectives: i) attracting mobile businesses (financial and non-financial) to domicile or do business in the UK; and ii) promoting the UK financial sector relative to other financial centres. This suggests the government wants to promote the competitiveness of an economic sector like finance – thus a hybrid of the (meaningful) private-company version and the incoherent country version. Yet official documents do not spell this out, so regulators would have to navigate the contours of this strange hybrid, without charts."

DP 4/22 mentions competitiveness several more times, each with subtly (or not so subtly) different perspectives, for example:

> "the international competitiveness of the UK economy (including in particular the financial services sector through the contribution of PRA-authorised persons)" [p.9]
> . . .
> The long-term competitiveness of the UK" [p.9]
> . . .
> the secondary competitiveness and growth objective [pp.9, 10, 24]

[17] Despite many economists' disdain for the idea of 'national competitiveness' in the economic sphere, efforts have been made to assess it. For example, the IMD has created a "World Competitiveness Ranking" of countries. Discussing its ca. 300 criteria is outside the scope here, but in its ranking for 2022, the "most competitive" country is Denmark, a country characterised by very strict financial services regulation (along with high corporate and individual taxes, and a strong social safety net.)

For the purposes of interpreting and implementing the new competitiveness objective that has been handed to it, we would first urge the PRA to clarify in public exactly what it understands these objectives to mean.

At the time of writing, the Financial Services and Markets Bill is at the Committee stage. It describes a "competitiveness and growth" objective, and it defines it thus (p37):

> **"1EB Competitiveness and growth objective**
>
> The competitiveness and growth objective is: facilitating, subject to aligning with relevant international standards— *20*
>
> (a) the international competitiveness of the economy of the United Kingdom (including in particular the financial services sector), and
>
> (b) its growth in the medium to long term." *25*

That is clear, at first glance, but on deeper examination it raises many questions. Several have already been expressed above, and we would urge the PRA to consider each carefully, and to refer to them explicitly in public as a way of anchoring this recognition for the longer term.

Yet we would also suggest focusing on some additional points.

5. Focus on the conflicts

It is quite normal for regulatory objectives to conflict with each other. What is crucial, is the framework and rules for how these conflicts are resolved.

We will focus on three conflicts – one explicit, and two implicit – that emerge from the "competitiveness and growth objective."

5.1 Competitiveness versus financial stability, consumer protection

As noted above, the UK government and others accept that there is potentially a conflict between the "competitiveness and growth objective", on the one hand, and the objectives of financial stability and consumer protection, on the other. This has been politically resolved by making the latter objective the **primary** objective, and the former the **secondary** objective. As the Chancellor of the Exchequer said at the Mansion House speech in July:

> "by making [a competitiveness and growth objective] secondary, we're giving the regulators an unambiguous hierarchy of objectives… with financial stability and consumer protection, prioritised."

That qualification is welcome, and essential. We would also urge that where there is any ambiguity over whether there is a clash between the primary and secondary objectives, the precautionary principle should be applied, and that the competitiveness objective should only be permitted to be invoked after it has been unambiguously demonstrated, and public justification given, that it poses no risk to financial stability or consumer protection.[18]

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[18] On the precautionary principle in finance, see *Towards a Normative Theory of Systemic (Financial) Risk*, Andrew Baker, Fabian Schuppert, and Jay Cullen | November 27, 2020, ESRC Working Paper, https://www.rebuildingmacroeconomics.ac.uk/normative-theory

We should highlight two further conflicts, which need careful consideration.

5.2 Competitiveness versus growth

While the conflict outlined in Section 5.1 is *between* the competitiveness and growth objective, on the one hand, and the stability and consumer protection objectives, on the other, the PRA must also take into account the fact that there is a conflict *inside* the competitiveness and growth objective. As section 2 above demonstrates, and as the global financial crisis showed clearly, a competitiveness objective likely conflicts with the growth objective.

The easiest – but the mistaken – approach to resolving this conflict would be to review the international evidence/literature, then conclude that "increased "competitiveness for the financial sector will tend to increase the growth of the UK economy." As Section 2 above makes clear, it is clearly not possible to reach such a conclusion, and that the balance of evidence laid out above suggests that a competitiveness objective is likely to hamper growth.

We are not aware of an explicit official hierarchy of objectives between "competitiveness" and "growth" to guide policy[19], so in the absence of formal guidance, the PRA should adopt the precautionary principle and only consider triggering a competitiveness objective when it is satisfied, in each particular case, that there has been a *unambuiguous demonstration, with public justification given,* that there is no conflict with the growth objective.

5.3 Competitiveness versus competition

Third, we see a conflict between the "competitiveness" part of the competitiveness and growth objective, and the (secondary) competition objective, as discussed in Section 3. Put simply, the **competitiveness** objective conflicts with the **competition** objective.

How so? Competition in private markets, within appropriate public-interest guard rails, can deliver efficiency, innovation, and can enhance UK productivity and growth, along with greater choice, resilience, good wages, and other benefits. Competition, again within public-interest guard rails, also complements regulators' efforts to promote consumer protection, not least as it allows people and businesses to exit abusive economic and financial relationships. However, large parts of the UK economy, as elsewhere, are characterised by oligopoly, where a few dominant firms enjoy significant market power, which enables them to stifle competition and treat their customers abusively[20]. There is extensive evidence that this market power has been wielded to the benefit of dominant firms and at the expense of smaller and medium-sized enterprises, both inside and outside the financial sector[21].

This means that whatever the absolute size, revenues, profitability and market power of financial institutions, any regulator with a competition objective needs also to consider changes in the relative size, revenues, profitability or market power of different firms, especially between dominant firms and smaller 'challenger' firms, as such changes will likely impact competition.

[19] One would presume that growth would be a higher priority, and perhaps this should be spelled out, given the extensive evidence in Section 2 that the two objectives may be in conflict.
[20] See, for example, De Loecker, J., Obermeier, T. and Van Reenen, J. (2022), 'Firms and inequality', IFS Deaton Review of Inequalities, https://ifs.org.uk/inequality/firms-and-inequality
[21] Ibid.

For example, changes to the Bank Levy in 2021 meant that the overseas activities of UK headquartered banking groups would no longer be subject to the Bank Levy. This change is consistent with a "competitiveness" objective, as it may seek to attract financial services activity to the UK, or to boost the profits of UK-headquartered banks.

However, the problem is, larger and more dominant (financial) firms will tend to have more extensive international operations than smaller firms, so this change is likely to boost the profitability and the market power of dominant firms relative to smaller firms. (It will also, by reducing tax revenue, likely reduce public goods such as education or infrastructure spending, which may impact smaller firms negatively too.) This change in the relative fortunes of big versus small firms will, in general terms, tend to reduce competition.

Likewise, a competitiveness objective may seek to prioritise large UK-based financial actors as "national champions," in an effort to help them compete globally with (say) U.S. or Chinese firms.

Such a 'national champions' approach in finance can inflict severe and long-lasting damage on the reputation of regulators.

We would cite as evidence here, of course, the last global financial crisis – but also more recently the Wirecard disaster in Germany, where regulators' efforts to promote a German "national champion" in payments, going as far as to take action against brave and responsible journalism by the *Financial Times* which was uncovering shady behaviour there, has caused long term damage to German regulators' reputation.

So increasing market power and reducing competition will make it harder for the PRA to pursue its primary objective of protecting consumers, as discussed above.

Overall, a pure competitiveness objective would tend to benefit larger firms over smaller ones, thus reducing competition. Thus the competitiveness and competition objectives are in tension.

5.4 Prioritising conflicting objectives.

It is important for the PRA to recognise explicitly that these highlighted conflicts exist between and within these regulatory objectives. Once these conflicts are recognised, policy can become clearer. We would suggest the following approach.

First, where there are conflicts, apply a clear and sensible hierarchy of objectives. This has already been made explicit in the conflicts between the primary and secondary objectives. But the PRA should develop and operationalise a hierarchical approach for these other conflicts too. The hierarchy should be designed to prioritise the interests of the UK economy, its citizens, its workforce, or its small and medium enterprises, and not prioritise the interests of the financial sector except subject to the below.

Second, given that the secondary objectives have the potential to single out the financial sector for special treatment, it is essential to allow this special treatment to apply only when it has been *unambiguously* demonstrated – with reasoning always made public – that this will

not conflict with the other objectives identified here – growth, competition, consumer protection and financial stability. If there is *any* doubt about possible damage, the precautionary principle should be applied so that the broad UK-wide objectives take precedence over narrow financial-sector ones. A competitiveness objective may not be triggered unless and until such public demonstration of no-conflict has been made.

Third, complementing this, and as a framing exercise, the Economists' letter identified a difference between "good" competitiveness (such as through promoting probity, safety, resilience) and "bad" competitiveness (such as luring foreign corrupt and criminal money through lax money laundering standards.) The PRA should always be clear about this and monitor for (and exclude) bad competitiveness -- and where there is doubt about the dividing line, apply the precautionary principle as outlined above.

Finally, as a way to counteract the enormous imbalance in resources and influence between the financial sector and its supporters, on the one hand, and those representing the interests of millions of consumers, workers, citizens, taxpayers and others – and amid the many potential conflicts between these groups and the financial sector – we would urge the PRA to consider ways to redress the imbalance: such as by giving disproportionate weight to the submissions and opinions of those non-financial or public-interest actors, versus the financial actors.

6. Conclusion

Many people, including a large number of eminent economists, have warned of the dangers posed by a competitiveness objective in financial regulation.

The political battle to remove this objective altogether appears to be all but lost. It is at least a good thing that at least the competitiveness objective has been relegated to secondary status. Given the dangers, it is essential to place more guardrails around that objective.

END

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