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Summary

The reform of financial markets is vital if the UK is to be upgraded to a high-investment, high-productivity and high-wage economy. The financial sector is a major employer and earner of foreign exchange, but it is not sufficiently supporting long-term investment in the UK domestic economy. Small, high-growth firms are frequently unable to access the bank lending they need, while the markets and institutions that trade shares in public companies have created excessive pressures towards short-termism. Reform of the UK's financial sector should therefore be focused both on improving the flow of capital to the businesses most in need of investment, and aligning the incentives among company directors, intermediary institutions and savers to promote longer-term investment.

This conclusion is based on three key propositions:

- 1. The profitability of the UK's finance sector rests in part on a failure to pass on the benefits of its rising productivity to the rest of the domestic economy.** Despite huge advances in information technologies and analytical capacity, the unit cost of intermediation to the non-financial economy was higher in 2007 than it was in the 1950s.
 - **The UK has a lower rate of investment than our major competitors, and less than is required to move to a higher productivity, higher wage economy.** After adjusting for the composition of industry across countries, the UK spends around 2 per cent of GVA on research and development (R&D), compared with 3 per cent in France and the US, and closer to 4 per cent in Japan and Finland.
 - **Financial markets influence both the demand for and the supply of investment.** On the supply side, they provide access to credit and capital. They also affect business demand for investment by intermediating the ownership of companies through share dealing.
 - **By not passing on the lower costs from productivity gains, financial markets are not supporting the rest of the economy as they should.** The unit cost of intermediating capital for the UK's non-financial economy rose by a third between 1950 and 2007.
- 2. Raising SME investment requires shifting the focus of bank lending to small, high-growth firms, and the development of new specialist banks.** UK banks are overly focused on real estate, leaving a gap in the supply of finance needed to improve productivity and growth in the economy.
 - **Although the supply of finance to SMEs has improved in aggregate since 2014, net lending to small businesses – those with less than 50 employees – has been negative in all but one quarter over the last five years.** There appears to be a significant finance gap for small, high-growth businesses, which are particularly important to shift the UK to a higher wage, higher productivity economy.
 - **The UK banking industry has an over reliance on traditional property collateral, and invests disproportionately in real estate and financial assets.** The ratio of real estate lending to business lending among UK banks is three times the average across the Eurozone.

- **The Bank of England should raise the relative cost of lending to real estate within its funding schemes, while the Government should look at supporting the private sector to use intellectual property as collateral.** Continuing to rely on horizontal interventions alone, such as the Funding for Lending Scheme, will not ensure finance reaches all the places it is most needed to upgrade the economy.
- **The Government should capitalise new specialist banks to provide lending to key sectors and regions.** By focusing on specific industries, technologies or geographic regions, specialist and public investment banks (such as the Green Investment Bank, or Germany's KfW) are able to develop expertise and thereby 'crowd-in' private investment.

3. Promoting longer-term corporate investment requires a stronger alignment of the incentives of companies with the savers who ultimately own their shares. By reforming executive pay, extending fiduciary duty to intermediary institutions such as fund managers and brokers, and ending exemptions for Stamp Duty Reserve Tax, the incentives for excessive short-termism in equity markets can be reduced.

- **Trading in shares is largely rewarded on the basis of relative performance, not long-term value creation, with high frequency trading adding negligible value to the economy.** Hedge funds, high frequency traders and propriety traders now make up 72 per cent of equity market turnover in the UK.
- **Short-term pressures in equity markets are passed through to company board rooms, leading to an excessive focus on share prices and short-term returns to shareholders.** A survey of more than 400 executives found that 75 per cent would sacrifice positive economic outcomes if it helped smooth short-term earnings.
- **Extending the legal fiduciary duty of pension fund trustees to asset managers and brokers would help align the incentives between companies and the savers who ultimately own their shares.** A new Responsible Ownership Commission should be established to apply the principle and support disclosure and compliance.
- **Hedge funds and other market makers should no longer be exempted from Stamp Duty Reserve Tax, in order to reduce the incentives for short-term trading.** The revenues generated could be used to create new reliefs in Corporation Tax and Capital Gains Tax to increase incentives for longer-term ownership of shares.

The IPPR Commission on Economic Justice is a landmark initiative to rethink economic policy for post-Brexit Britain

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IPPR Commission on Economic Justice

