FINANCING UP: WHY LEVELLING UP REQUIRES PURPOSE-DRIVEN FINANCE ORGANISATIONS

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The views within this report are those of the Finance Innovation Lab alone.

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The Finance Innovation Lab builds power to transform the financial system for people and planet. We cultivate a community of systems-changemakers and work on initiatives that impact mental models and power dynamics in finance for deep, lasting change. Our work focuses on growing purpose-driven finance, shifting mainstream finance, influencing law, regulation and policy, and building our community.

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EXECUTIVE SUMMARY

There is widespread agreement that the UK government's agenda to 'level up' the country to "end the geographical inequality which is such a striking feature of the UK" is vitally important. However, discussion of the financial sector's role in helping create this regional inequality – and of how to reform it to support the levelling up agenda – has been scarce to date. This short paper aims to help fill that gap.

How the UK's banking system contributes to regional disparities

We argue that at the heart of the problem is the UK's highly unusual banking system, which is dominated by a small handful of large, mostly London-based, shareholder-owned commercial banks. This system has major negative implications for small- and medium- sized enterprises (SMEs), households and individuals.

SMEs provide over 60% of private sector employment and are the lifeblood of local economies but do not get the support they need from the financial system to grow and thrive. Before the Covid-19 pandemic, no more than 5% of bank lending went to SMEs.

We identify three key reasons why the large bank-dominated system fails SMEs:

1. **Scale**: Lending to SMEs, which involves relatively small loans with high transaction costs, is unattractive for large banks.
2. **Centralisation and lack of proximity**: The scale-back of branch networks has had major impacts on SMEs' ability to conduct the relationship-based banking they need.
3. **Ownership and governance**: The dominance of a single, 'shareholder bank' model has driven the large banks away from SMEs, as they are perceived as riskier and less profitable than alternatives.

Households and individuals also experience negative impacts, particularly those in deprived areas and rural areas, which have been the most affected by the closure of bank branches. Under dominant bank business models, those the mostlikely to need branch-based banking are the least likely to have access to it. High levels of household debt, exacerbated by the pandemic, are also reflected in the UK's regional inequalities.

Addressing the problem through 'stakeholder banks'

Thankfully, alternatives to the centralised and large bank-dominated model exist and have proven highly successful in other countries in supporting regional and local economies to thrive. International evidence demonstrates that decentralised, purpose-driven finance institutions – sometimes called 'stakeholder banks' to distinguish them from 'shareholder banks' – outperform the UK's model on a wide range of measures. Compared with shareholder banks, stakeholder banks:

- Lend proportionately more to the real economy, including small businesses
- Maintain larger branch networks
- Produce more consistent and less volatile returns
- Have safer business models with greater loan quality
- Help to reduce regional inequalities.

This outperformance is explained by lower costs of capital, less risky business models, local accountability embedded in governance and ownership structures, and localised and decentralised banking models with deep community roots.

The UK has a small but growing purpose-driven ecosystem of stakeholder financial institutions, including community development finance institutions, credit unions, and ethical and mutual banks and building societies. A new policy approach that combines purpose-driven regulation with targeted but proven initiatives such as a Community Reinvestment Act, could help this ecosystem grow and thrive and provide the diversity and regional and local economy-focused banking models that the UK so sorely needs.

THE PROBLEM: HOW THE UK'S FINANCIAL SYSTEM EXACERBATES REGIONAL INEQUALITY

Small businesses, banks and levelling up

Small- and medium-sized enterprises (SMEs) are widely recognised as the lifeblood of local economies. At the start of 2020, the UK's SMEs accounted for 60% of private sector employment and half of turnover.[i] It is well known that successful businesses also create spillover benefits for local areas, keeping wealth circulating in local economies.[ii]

It is also well known that UK SMEs face a significant finance gap – estimated at £22 billion in a 2019 speech by former Bank of England Governor Mark Carney[iii] – especially in relation to working capital and for businesses seeking to expand. Recent research has found that pre-Covid, only 2–5% of UK bank lending went to SMEs.[iv] These problems are particularly acute in less well-off regions. The government's 2022 Levelling Up White Paper identifies "sharp differences in access to financial capital across different parts of the UK", with regional 'debt gaps' – between the supply of bank lending and the potential demand – of £2–3 billion a year.[v] Around a third of all bank lending to SMEs is concentrated in London and the south-east.[vi] Inequalities in equity financing are extreme: a study by the Department for Business, Energy and Industrial Strategy (BEIS) of equity finance found that between 2011 and 2017, London, the south-east and east of England received an astonishing 75% of all invested funds.[vii] In other words, the finance sector as currently structured is failing to meet the needs of SMEs. This is damaging domestic local economies and thus is likely holding back the development of regions outside London. As the white paper puts it, "financial activity [is] concentrated in relatively few areas" and this "actively contributes to spatial differences in productivity, jobs and living standards".[viii] While central government initiatives, such as the British Business Bank's Regional Investment Funds, have made efforts to fill this gap, clearly far more needs to be done.

In fact, the UK performs poorly on productive investment of all kinds. Since 1997, our rates of investment to non-financial firms have been the lowest in the OECD.[ix] In 2019, only 8.5% of bank loans were to non-financial firms of any size, down from 80% a century ago[x]: 26% went to other financial firms and 55% to real estate lending.[xi] This split has barely changed since the start of the financial crisis in 2008. In other words, our financial system is highly tuned to financing and trading existing assets rather than to creating new ones, especially new productive capital, whether tangible or intangible, particularly in smaller companies outside London and the south-east.

The UK is highly unusual in that its banking system is dominated by a small handful of large, mostly London-based, shareholder-owned commercial banks. This creates several problems:

1. **Scale.** The disadvantages of large, complex bank organisations in small business and relationship-based loans are well established in the academic literature.[xii] SME lending, which involves relatively small loans with high transaction costs, is unattractive for large banks. Research shows these banks are more likely to specialise in activities with economies of scale, such as providing investment banking services to large corporate clients and derivatives trading.[xiii] This comes at the expense of their capacity to serve SMEs and support local economies. Big banks' provision of small loans also tends to be less resilient in

times of crisis compared with those that can draw on long-term relationships with borrowers.[xiv] As co-chair of the All-Party Parliamentary Group (APPG) on Fair Business Banking, Kevin Hollinrake MP, observes: "It is an old adage that banks will lend you an umbrella in fair weather and then ask for it back again when it begins to rain."[xv]

2. **Centralisation and lack of proximity.** In recent decades, big banks have eroded their branch networks and capacity to conduct relationship-based lending in favour of managing risk centrally through algorithmic credit scoring and demands for collateral. One in four SMEs have said this demand for collateral constrains their ability to borrow.[xvi] The APPG inquiry heard that bank relationship managers may now manage up to 3,000 clients each, making it impossible for them to assimilate 'soft' information about borrowers' business prospects and creditworthiness.

   It is well established that decentralised banks are better at serving peripheral regions. The crucial factor appears to be the 'functional distance' between customers and those making decisions about them.[xvii] For instance, research in Italy has found that banks headquartered in the wealthier north lend less to small businesses than those headquartered in the south,[xviii] and that small businesses in less developed regions far from bank headquarters are at a particular disadvantage.[xix] In the UK, this effect contributed to the regionally unequal impacts of the 2008 financial crisis: regions further away from bank headquarters saw lending decline more through a 'flight to headquarters' effect.[xx]

   This has obvious implications for the levelling up agenda. As Professor Colin Mayer puts it: "…the spatial skew in the allocation of finance has been compounded by the extreme, and internationally exceptional, spatial concentration of Britain's finance industry in London."[xxi] [xxii] The Levelling Up White Paper acknowledges that this creates a 'liability of distance' for small businesses in other regions.[xxiii] As the APPG inquiry concluded: "The centralisation of the UK's finance industry perpetuates the centralisation of its economic growth in London and the south-east."[xxiv]

3. **Ownership and governance.** The UK banking system is also unusual in being largely a monoculture (some would say an oligopoly) of shareholder-owned banks. This imperative to maximise 'shareholder value' has contributed to the drive towards centralisation and market concentration. It also makes SME lending less attractive than more profitable activities such as mortgage lending. Further, where banks do lend to SMEs their track record has been tarnished by a number of misconduct scandals, from the RBS Global Restructuring Group to the mis-selling of interest rate hedging products.[xxv] These scandals have contributed to widespread mistrust among SMEs: one survey found that just 13% trust their bank to act in their best interest.[xxvi] And yet their dominance of the market leaves many with few alternatives: in 2015, the Competition and Markets Authority found that 80% of SME lending came from the 'big four' banks.[xxvii] A recent inquiry by the APPG on Fair Business Banking found that these factors have left many small business owners – particularly entrepreneurs of colour – discouraged from expanding or even from pursuing their business idea at all.[xxviii]

In addition, the UK's 'top-heavy' banking system has been shown to weaken the country's resilience to financial shocks.[xxix] Because the few banks at the top are very large relative to the size of the UK economy, and highly interconnected with the global financial system, they leave us almost uniquely exposed to shocks originating in other parts of the world.[xxx] Additionally, because they share similar business models, they are more likely to shoulder the same problems at the same time – increasing the chances that an individual bank failure could turn into a system-wide collapse.

In summary, a large body of evidence would suggest that there is a trade-off between a focus on the global 'competitiveness' of large, centralised, shareholder-owned banks, and building a banking system capable of delivering on levelling up.

Households, banks and levelling up

As well as small business lending, the relationship between banks and individual customers deserves attention in the context of levelling up. An estimated 1.2 million adults do not have a bank account (or are 'unbanked'),[xxxi] with a disproportionate number of these living in deprived areas. Large banks seeking to protect their margins have also responded to the rise of online banking by closing branches they deem 'uneconomic' on a significant scale. Since 2015, banks and building societies have announced 4,976 branch closures, a rate of around 54 every month.[xxxii] This has contributed to the decline of local high streets and to financial exclusion. It also affects small businesses by reducing access to face-to-face support; research even suggests that SME lending has declined in areas where branches closed.[xxxiii]

As the Levelling Up White Paper notes, rural areas have been more heavily affected by this problem, losing 19% of branches compared with 15% in urban areas.[xxxiv] Furthermore, 12 million people living in rural or remote areas have poor internet access, which makes it difficult to bank online.[xxxv] Under dominant bank business models, those the most likely to need branch-based banking are therefore the least likely to have access to it. Co-chair of the All-Party Parliamentary Group on Fair Business Banking, Kevin Hollinrake MP, recently drew attention to the implications of this for levelling up, noting that in his Yorkshire constituency 50 bank branches had closed since 2015, with just 12 remaining.[xxxvi]

Another issue of concern is the UK's high and growing levels of household debt. In 2017 the Bank of England warned of a 'spiral of complacency' about personal debt, amid concerns that consumer credit was reaching unsustainable levels.[xxxvii] Since then, the pandemic has widened the gulf between better-off households (many of whom have built up substantial savings) and low-income households who were already struggling to make ends meet. The number of UK households struggling with large debts rose by a third in 2021, even before the onset of the cost of living crisis.[xxxviii] This number is now likely to be substantially higher: by some estimates as many as 10 million people are now 'over-indebted', meaning they are behind on bills or are finding their debt repayments a heavy financial burden.[xxxix] Debt advice charities are reporting a surge in demand for help, as well as concerns that customers are being pushed into inappropriate and unaffordable high-cost credit products to pay for basic essentials like food and energy. People living in the poorest areas of England are twice as likely as people in the wealthiest areas to have borrowed more or used more credit than usual.[xl] Particularly as interest rates rise, more money spent servicing debt repayments will mean less money circulating in local economies, holding back consumer demand. To the extent that debtors are more likely to be located in low-income areas, and creditors to be institutions located in London and the south-east, this also represents a flow of wealth from the regions to the economic centre. Both of these mechanisms threaten to directly undermine the levelling up agenda.

In addition to supporting household incomes to prevent people from facing problem debt in the first place, there is thus an urgent need to widen access to credit on fair and affordable terms from local, responsible institutions with borrowers' best interests at heart.

COVID-19 LOAN SCHEMES

The response to the pandemic – in particular the government-backed loan schemes that sought to channel emergency funding to small businesses – has helped to entrench the dominance of large incumbent banks even as it has exposed their shortcomings. The Coronavirus Business Interruption Loan Scheme (CBILS), under which the government underwrote 80% of the value of loans, was quickly supplemented by the Bounce Back Loan Scheme (BBLS), which underwrote 100% of the smallest loans. This was largely in response to the failure of big banks – the scheme's accredited partners through which loans would be disbursed – to extend credit on the scale needed.

By 21 April 2020, CBILS had lent just £2.8 billion of the £330 billion the Chancellor had pledged to underwrite. Small businesses complained that they were being turned away, could not get a response, or had been asked to meet prohibitively complex conditions to demonstrate that they would still be viable after the crisis.[xli] A statement by the London Chambers of Commerce (LCC) complained that "SMEs are being offered loans with outrageous interest rates and demands for security from every possible source" – forcing the government to intervene to limit these predatory practices.

As the LCC noted, large banks' failure on this score reflected the fact that they are simply not set up for SME lending in good times, let alone in bad times: "Banks have whittled away at their capacity to engage effectively with small and medium enterprise. The frontline of banks are massively overburdened and do not have the depth of relationship or decision-making authority that they need for quick action. It has become painfully obvious that most lending decisions are being taken on algorithmic assessment of the risk of a business sector rather than the specialist ability of a small business banker to understand an individual company."[xlii] In other words, the problems we explore in this paper left the UK banking system ill-equipped to support the economy through the pandemic.

THE ALTERNATIVE: HOW COULD FINANCE BE REFORMED TO BETTER SUPPORT LEVELLING UP GOALS?

Purpose-driven finance

In our 2018 report *The Regulatory Compass* we argued that, "If we want a financial system that meets its social purpose, we also need to take much more of an interest in the purpose of individual businesses within that system."[xliii] As we have seen, the UK's predominance of large, shareholder-owned banks makes it difficult to achieve outcomes such as narrowing regional inequalities or improving the financial health of the poorest in society. The institutions we rely on simply are not designed to achieve those outcomes, nor is it an explicit part of their purpose.

Instead, we need to actively nurture business models and ownership structures that *align* with the social outcomes we want to achieve. We need to promote *diversity,* not just competition. As we said in *The Regulatory Compass,* "If customers technically have a wide choice of banks… but all the options on offer are similar and none are genuinely meeting their needs, something is wrong."[xliv] Unless this problem is addressed, we are reduced to playing 'regulatory whack-a-mole' to try to stamp out bad practice, or – if we are lucky – encourage good practice. In either case, we are going against the grain of the system.

In the case of levelling up, there is a wealth of international evidence on the kinds of lending institutions that best support these goals. There is also good evidence that diversity in itself supports financial system stability.[xlv] In short, we need to nurture and grow the ecosystem of decentralised, purpose-driven finance institutions. Sometimes called 'stakeholder banks' to distinguish them from 'shareholder banks', these may include local mutual and co-operative banks, ethical banks, community development finance institutions (CDFIs), credit unions, and publicly owned institutions.[xlvi]
International evidence demonstrates that such banks outperform on a wide range of measures.[xlvii] Compared with the UK's existing model, stakeholder banks:

- Lend proportionately more to the real economy,[xlviii] including small businesses
- Maintain larger branch networks[xlix]
- Produce more consistent and less volatile returns[l]
- Have safer business models with higher loan quality[li]
- Help to reduce regional inequality.[lii] [liii]

There is also considerable evidence that stakeholder banks are less 'procyclical' in their behaviour and more resilient in times of crisis, when they are less likely to fail or cut back lending.[liv] [lv] In the five years following the 2008 crisis, UK bank lending to non-financial businesses fell by around 25%, while over the same period the German *Sparkassen* and co-operative banks *increased* their lending by around 20% (see box on page 10).[lvi] In the United States, counties with higher shares of local and independent banks had better economic outcomes after natural disasters.[lvii] In today's volatile economic climate, purpose-driven banking could thus play a crucial role in stabilising local economies.

INTERNATIONAL CASE STUDY: THE GERMAN BANKING SYSTEM

Germany's 'three pillar' banking system consists of a network of local public savings banks called *Sparkassen*, and 819 co-operative banks, alongside big commercial banks. A recent study concluded that it is the most decentralised banking system among several advanced economies, with the close proximity to SME borrowers enabling the banks to access 'soft' information and lend more consistently. The *Sparkassen* have been shown to reduce SMEs' financial constraints by 3–10%,[lviii] and are widely credited with helping to close Germany's regional divisions. Between 1999 and 2020, German co-operative banks doubled their business lending to 323 billion euros.[lix]

Local stakeholder banks have been key on-lending partners for the support provided by the German national investment bank KfW to small businesses – offering an important counterexample to the difficulties faced by the UK's Covid loan schemes (see box on page eight). The positive effects of this model are particularly strong for the most deprived regions, where co-operative and savings banks are often the only banks available and are critical players in supporting growth and jobs.[lx]

Various factors help to explain the outperformance of stakeholder banks:

Lower cost of capital. Because these institutions may be profit-making but are not profit-maximising, their cost of capital is lower which allows them to be financially sustainable while carrying higher costs (such as a larger branch network and more relationship managers).

Less risky business model. The lower cost of capital also limits their incentives to over-expand, over-concentrate or take on excessive risk in the pursuit of short-term return. In many cases, this is linked to an explicit public service mandate which limits them to serving specific regions or to delivering their social purpose. Such mandates can also help to ensure that banks are contributing to wider imperatives such as the transition to net zero. For example, German co-operatives and local savings banks have been key partners in delivering the Energiewende, or transition to renewable energy.

Local accountability. Ownership and governance structures such as the credit union 'common bond' often embed accountability into local communities while limiting opportunities for investors to take money out of the business – thus ensuring that profits are reinvested in those communities.[lxi]

Localised and decentralised models. While these banks may co-operate in national networks, the networks are accountable to local banks rather than the other way round. This enables the banks to remain focused on their core mission of relationship-based lending within a given locality.[lxii] It also means that local deposits are recycled into local loans, keeping wealth recirculating in the local economy rather than being channelled to more prosperous areas via a single, centrally-managed balance sheet.

Deep community roots. This factor makes the banks less likely to withdraw credit indiscriminately from entire regions during a panic or downturn. The benefits of such models for the aims of 'levelling up' are obvious.

Given the benefits outlined, the decline of the UK's stakeholder banking sector over the past half century may help to explain the wide regional finance gaps and other poor economic outcomes in the country. Expanding the stakeholder banking, or 'purpose-driven finance', sector is thus more likely to deliver on levelling up goals than focussing on the existing incumbent financial institutions. This was recognised by Andy Haldane, the government's former Levelling Up tsar, who wrote in 2021 that "the loss of local banks with local knowledge has widened [regional finance] gaps. Plugging them requires a national network of local banks providing not only long-term funding to start-ups and scale-ups but business advice too."[lxiii] Nurturing a more diverse banking ecosystem would also improve the health of the whole system, making it more resilient to shocks and improving consumer choice and meaningful competition.

PURPOSE DRIVEN FINANCE IN THE UK

Purpose-driven finance institutions already exist in the UK but they need to be supported and scaled up to grow their market share. Below we summarise the existing contribution of the sector to 'levelling up' goals and the key challenges faced in expanding this contribution.

COMMUNITY DEVELOPMENT FINANCE INSTITUTIONS (CDFIs)

There are around 50 CDFIs in the UK, which have lent over £1 billion to small businesses since 2009.[lxiv] Their mission is to provide alternative finance for businesses and individuals excluded by mainstream lenders, with a focus on improving economic opportunity in deprived areas. Under the Regional Growth Fund, 87% of CDFI lending went to regions outside London and the south-east – a full 25 percentage points more than the average of all UK SME lending.[lxv] 30% of CDFI lending goes to the most deprived areas (those in the bottom two deciles of the Index of Multiple Deprivation), compared with just 13% of all bank lending.[lxvi]

The APPG on Fair Business Banking gives the example of two entrepreneurs seeking to take over the successful Prima bakery in Cornwall, which at the time employed 19 people. When the sale of the entrepreneurs' property fell through, their bank would no longer consider it as collateral. However, they were accepted for £20,000 of finance from SWIG Finance, a CDFI, to safeguard the 19 jobs. The business has since grown four-fold and now employs 96 people. This is a good illustration of how big banks' preference for collateral and algorithmic credit-scoring approaches over a more relationship-driven lending model can disadvantage sound businesses that cannot meet these requirements – and businesses like these are disproportionately likely to be located in less wealthy parts of the country where property values are lower. By contrast, purpose-driven finance institutions are more likely to help such businesses to survive and thrive.

Because CDFIs do not take deposits and tend to rely on grants or social investment to fund themselves – while sustaining high levels of default due to the relatively more risky client base they serve – they can struggle to become financially sustainable. This means there is a key role for government in supporting the sector to grow. Detailed modelling by Responsible Finance shows that if the UK government committed £50 million a year in new first-loss capital for five years, this could add over £1 billion in new lending capacity for CDFIs.[lxvii] Expanding tax relief to encourage ordinary people to invest in their local CDFIs could also help the sector to access capital.

CREDIT UNIONS

In 2021 there were around 395 credit unions in the UK, lending £1.75 billion to 2 million members.[lxviii] Credit unions tend to serve individuals primarily, although they can now lend to small businesses as well. The 2021 Woolard Review of change and innovation in the unsecured credit market concluded that credit unions and CDFIs offer a "valuable alternative to high-cost credit" for struggling households, but that reform is needed to help them grow and scale up to meet demand.[lxix] This could include liberalising credit union regulations to enable them to offer a wider range of services. We might also look to initiatives such as the Welsh Tenancy Saver Loan scheme, to help people who fell behind on rent during the pandemic to apply to a credit union for a low-interest loan to clear the debt, underwritten by the Welsh Government.

The Woolard Review also noted the need for more consumer awareness of purpose-driven finance institutions like credit unions and CDFIs, citing evidence that many people take out inappropriate high-cost credit products simply because they are unaware of the alternatives. Greater awareness could support financial inclusion and thus the financial resilience of communities in need of 'levelling up'.

ETHICAL, SUSTAINABLE BANKS AND BUILDING SOCIETIES

These institutions provide a similar range of retail banking services to shareholder banks, including current accounts, loans and savings, but are driven by a social or environmental mission that is embedded in their ownership models and governance structures. In the UK these include members of the Global Alliance for Banking on Values: Triodos, Charity Bank and Ecology Building Society.

MUTUAL BANKS

The UK previously had one of the largest mutual banking sectors in Europe, although most of these were building societies. Demutualisation – intended to enable these institutions to access capital and broaden services – in fact simply resulted in almost all former building societies being taken over by large shareholder-owned banks.[lxx] The Co-operative and Community Benefit Societies Act 2014 has resulted in several mutual banks seeking to revive the model, although sadly the act has not in practice created a suitable regulatory environment for mutual banking start-ups. Almost all of these are regionally focused and motivated by the desire to transform the banking system to better serve regions outside the south-east. They include South West Mutual and Avon Mutual in the west of England, Salt Mutual in Bradford, North West Mutual (a joint venture between Preston, Wirral and Liverpool councils), Northern Mutual (Northern Ireland) and Banc Cambria, supported by the Welsh government.

The single greatest barrier for these institutions remains access to capital. While historically mutuals would have grown organically by taking deposits from their members, modern mutuals face a 'catch-22' situation whereby they need to raise significant capital to begin trading in the first place.[lxxi] Mainstream investors are likely to demand levels of return that are incompatible with these institutions' social purpose and desire to do banking differently – that is, by growing organically through patient lending and relationship building. Complex regulation designed around the business models of large incumbent banks can also be a barrier for aspiring mutuals. There is clearly a role for government policy, therefore, in jump-starting this sector, creating socially-owned institutions with a specific mandate to support local economies in areas that need 'levelling up'.

CONCLUSIONS: TOWARDS A NEW POLICY APPROACH

Purpose-driven finance

In our 2018 report *The Regulatory Compass* we noted that "finance is not an end in itself. It is a system that fulfils a certain set of critical functions for the rest of the economy, and by extension for society and the environment."[lxxii] We argued that regulators' mandates should reflect the social purpose of the firms they regulate – and they cannot afford to assume that maintaining 'competitiveness', market integrity or stability among incumbent firms will be an adequate proxy for that. After all, "sustaining a system is only an unqualified good if the system is achieving the right things in the first place".[lxxiii] Nor can the regulators assume that limiting themselves to such objectives enables them to be 'market-neutral'. On the contrary, this will tend to favour established firms and ways of doing business, regardless of whether they are meeting society's needs or not.

Instead, regulators' mandates should explicitly require them to ensure that the financial system is delivering on its ultimate purpose – including improving people's financial wellbeing or financial inclusion (in the case of the Financial Conduct Authority), and supporting the wider economy through sustainable, productive and regionally equitable investment (the Prudential Regulation Authority/Financial Policy Committee). The government's reforms of the Future Regulatory Framework, and the upcoming Financial Services and Markets Bill, offer a once-in-a-generation opportunity to do this, in two key ways:

- Firstly, by elevating financial inclusion objectives, regulators can be tasked with baking this key outcome into all future regulation. Over 30 public interest groups have called for this,[lxxiv] including influential parliamentarians such as Lord Holmes of Richmond.[lxxv]
- Secondly, as over 50 leading economists have recently noted,[lxxvi] the government's proposed 'international competitiveness' statutory objective is likely to undermine this agenda and levelling up, by giving regulators a conflicting duty to support the growth of internationally oriented financial firms, rather than focussing on their duty to promote the interests of the country as a whole. As outgoing FCA chair Charles Randell has said: "I don't think that we can achieve long term economic growth if we put the interests of the financial services industry ahead of the interests of other people in our society – producing an island of prosperous financial services professionals in a sea of inequality. That type of growth would be the opposite of levelling up."[lxxvii]

An agenda to grow purpose-driven finance

The APPG on Fair Business Banking recommends the government do more to provide capital to mutual banks and CDFIs, which they could then multiply by lending to thousands of small businesses across the country. This could be achieved through various mechanisms, including under the UK Infrastructure Bank's mandate to support levelling up, the Northern Powerhouse Investment Fund and the Dormant Assets Fund. The government has already promised to consult on destinations for the next wave of expansion of the Dormant Assets Fund, including considering options on 'financial inclusion and social investment'.[lxxviii]

Covid loan schemes have proved that the existing big-bank dominated system is not a good vehicle for delivering increased support for SMEs. Such state support could deliver significantly more public value if, instead of entrenching the advantages of incumbent banks, it was expressly targeted at growing the UK's purpose-driven finance sector. This would be a real investment in a critical piece of the institutional puzzle required for levelling up.

The Incentivised Switching Scheme also offers a precedent for regulators forcing mainstream banks such as RBS to channel money to their competitors in order to diversify the sector. While this money mainly went to commercial challenger banks, it is easy to see how the approach could be adapted to provide a source of funding for mutual and ethical banks, CDFIs and credit unions. Here the government could draw on the successful model of the Community Reinvestment Act in the US, enacted in 1977 following demands by low-income communities to address the practice of 'red-lining' whereby mainstream banks refused to lend to entire neighbourhoods who were deemed insufficiently creditworthy. The act requires banks to demonstrate that they are channelling a minimum level of funding to low-income neighbourhoods. If they are not willing to lend themselves, they must provide support to local purpose-driven institutions who assume this role. Regulators have a number of sanctions to ensure that banks comply with their obligations under the act, including preventing mergers and acquisitions.

Regulation may also need to be reformed to better accommodate relationship lending models. Risk-weighted capital requirements tend to discourage this type of lending by treating it as more risky, instead favouring risk management techniques that can be easily captured in models. Yet evidence suggests that benefits in the form of the 'soft' information and specialisation enjoyed by local banks can actually outweigh the risks.[lxxix] The sheer complexity of regulation also tends to favour big banks that can afford to sustain large compliance teams. Both factors drive the sector towards greater concentration, the opposite of what the economy needs.[lxxx]

The UK has a major opportunity post-Brexit to rethink the role of its financial system in supporting the wider economy, and in particular the development of its regions. There is ample evidence that our current system is not working. We also know what *does* work in other countries: purpose-driven financial institutions, rooted in and accountable to local communities. The seeds of such an ecosystem are already here in the UK today, but they are struggling to flourish against the odds in a system stacked against them.

The levelling up agenda represents a unique opportunity to change this. We hope this paper has helped to set out some ideas for how these institutions could be supported to grow and flourish, to create a financial system that works for small- and medium- sized enterprises, local communities and the under-served. In this way, the financial system could become a major driver of levelling up, rather than a barrier.

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ENDNOTES

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