Richard Ridyard (Senior Lecturer in Law at Liverpool John Moores University) – Written evidence (PMG0018)

1. This submission addresses questions 1 (whilst picking up on a key theme of 7) and 9 of the Committee's inquiry into the growth of private markets in the UK following reforms introduced after 2008.

2. As a senior lecturer in law, programme director, and the research lead for the Business, Corporate, Financial and Technology Unit at Liverpool John Moores University, I have worked on questions of financial law and regulation for several years. This includes research on the impact of regulatory reforms since the financial crisis of 2007-2009. I have also explored alternative reforms for corporate governance in financial firms, which include changing the composition of bank executive remuneration packages and the liability regime for bank shareholders. In another relevant example, I analysed the risks attached to deposit insurance in the Eurozone. I have won various research grants, including those from the Society of Legal Studies, the Institute of Humane Studies, and LJMU. My published work has been cited by the Quarterly Review of Economics and Finance, Seattle University Law Review, and the Washington University Law Review, amongst others. I am one of the founding co-managing editors of the Journal of Artificial Intelligence, Risk Regulation, Law, and Policy. And I am a former associate editor of the Oxford University Commonwealth Law Journal. I have also been interviewed by the media, including BBC News.

Has Bank lending to the real economy in the UK reduced as a proportion of the total volume of finance provided annually since 2008? If so, to what extent can this change be attributed to the reforms to the UK's regulation of bank capital and liquidity requirements? To what extent has any reduction led to an increase in finance by private markets?

3. One way to assess this is to examine the respective contributions of banks and non-bank financial institutions (NBFIs) to any net increase in lending to UK businesses. Between 2008 and 2023, there was an approximate £425 billion increase in net lending. And nearly all of that can be attributed to NBFIs.[1] Further, NBFIs now account for 50% of the stock of corporate lending.[2]

4. An alternative approach considers any changes to the share of UK financial assets by subsector. Two important trends emerge from the 2007 to 2020 data, which in turn produce a striking correlation.[3] The first concerns banks, which in 2007 accounted for 56% of the UK's financial sector assets. By the end of 2020, that figure had shrunk to 51%. The trend for NBFIs markedly differs, countering the 5% decline banks experienced with a 5% increase. Amounting to 44% in 2007, NBFIs' share of UK financial sector assets rose to 49% in 2020. Over a

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[1] Lee Foulger, 'Non-bank risks, financial stability and the role of private credit' (Speech at the Deal Catalyst/AFME direct Lending and Middle Market Finance Conference, London, 29 January 2024) <www.bankofengland.co.uk/speech/2024/january/lee-foulger-keynote-address-at-the-dealcatalyst-afme-european-direct-lending> accessed 10/09/2025.

[2] Bank of England, 'Financial Stability Report - December 2023' (2023) <www.bankofengland.co.uk/financial-stability-report/2023/december-2023> accessed 10/09/2025.

[3] Bank of England, 'Assessing the resilience of market-based finance' (2021) <www.bankofengland.co.uk/report/2021/assessing-the-resilience-of-market-based-finance> accessed 10/09/2025.

similar timeline, the NBFI sector doubled in size, whilst the banking sector increased by far less, at 60%.[4]

5. Changes in the UK government bond market are consistent with the trends identified above. Government relies heavily on the gilt market for its financing. But more than that, it provides the basis for a lot of secured lending and is viewed as a source of safe assets. As a result, the gilt market is inextricably bound up with other financial markets as well as the real economy. NBFIs have become major holders of gilts and users of gilt repo.[5] And while bank dealers continue to provide liquidity to the gilt market, their capacity to do so, proxied by their asset holdings, has barely changed since 2008. The stock of gilts in issue, however, has tripled.[6]

6. Similar patterns can be observed elsewhere. For instance, in the Eurozone, NBFIs provide around 50% of business debt financing.[7] Growth rates bear similarities too. Since 2008, more than two-thirds of the growth in the size of the eurozone financial system has

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[4] Andrew Hauser, 'A journey of 1000 miles begins with a single step: filling gaps in the central bank liquidity toolkit' (Speech at a Market News International Connect Event, Chartered Accountants' Hall, London, 28 September 2023) <www.bankofengland.co.uk/speech/2023/september/andrew-hauser-speech-at-market-news-international-connect-event> accessed 10/09/2025.

[5] Robert Czech, Bernat Gual-Ricart, Joshua Lillis and Jack Worlidge, 'The role of non-bank financial intermediaries in the 'dash for cash' in sterling markets' (2021) Financial Stability Paper No.47 <www.bankofengland.co.uk/financial-stability-paper/2021/the-role-of-non-bank-financial-intermediaries-in-the-dash-for-cash-in-sterling-markets> accessed 10/09/2025.

[6] Nick Butt, 'Market resilience, non-bank financial institutions and the central bank toolkit – practical next steps' (Speech at the ISDA virtual conference on Procyclicality and Margin Practices, 12 March 2024) <www.bankofengland.co.uk/speech/2024/march/nick-butt-keynote-speech-at-isda-virtual-conference-procyclicality-and-margin-practices#:~:text=The figures are striking.,footnote> accessed 10/09/2025.

[7] Alternative Credit Council, 'Financing European Business: Non-bank Lending and Economic Recovery' <https://acc.aima.org/research/financing-european-business.html> accessed 10/09/2025.

stemmed from NBFI entities, whose total assets increased from €23 trillion to €54 trillion as at the end of 2023.[8] In 2024, the European Central Bank also reported that NBFIs held almost 60% of the total assets of the eurozone financial system. And the total assets of these entities were more than three times the size of the eurozone economy.[9]

7. Globally, in 2023, the size of the NBFI sector swelled 8.5%, more than double the pace of banking sector growth (3.3%), compared to 2022. This raised the NBFI share of total global financial assets to 49.1%.[10]

8. The foregoing points towards a significant shift. When it comes to financial assets held and lending to businesses, the growth of NBFIs since 2008 far exceeds that of banks. Furthermore, businesses are becoming increasingly reliant on NBFIs to fund their activities.

9. In search of explanations for the financial crisis of 2007, banks were especially pilloried for lacking the capital to absorb losses. Hence, regulators pursued reforms to capital requirements, amongst other things, aimed at making banks more resilient to economic shocks. However, capital requirements present a quandary. And there is a strenuous dispute about the cost of capital for banks and the impact on lending.

10. One view flows from the Modigliani-Miller theorem.[11] Accordingly, under structured assumptions, capital requirements have little impact

[8] European Central Bank, 'Eurosystem response to the EU Commission's consultation on macroprudential policies for non-bank financial intermediation (NBFI)' (2024) <https://www.ecb.europa.eu/pub/pdf/other/ecb.eurosystem_response_EUcommission_on_macroprudential_policies_NBFI_202411~a38ef4423d.en.pdf> accessed 10/09/2025.

[9] ibid.

[10] Financial Stability Board, 'Global Monitoring Report on Non-Bank Financial Intermediation' (2024) <www.fsb.org/2024/12/global-monitoring-report-on-non-bank-financial-intermediation-2024/> accessed 10/09/2025.

[11] Franco Modigliani and Merton H. Miller, 'The Cost of Capital, Corporation Finance and the Theory of Investment' (1958) 48(3) The American Economic Review pp.261-297.

on bank lending and economic activity. Although this primarily applies to a situation in which a firm has equity, rather than one that involves raising equity.[12] Some commentators, more recently, have gone further, concluding that bank equity is not socially expensive. They, moreover, argue that high leverage is unnecessary for banks to perform their socially valuable functions and likely renders banking inefficient.[13]

11. In line with this, others claim that equity issuance costs are modest, and raising capital requirements has a marginal impact on the cost of funding for banks.[14] This conclusion is reached on the basis that banks with greater capitalisation could issue less risky, and thus cheaper, equity. If this holds, then banks could recapitalise while maintaining the same portfolio of loans.

12. These views have not been entirely accepted in either theory or practice. An alternative view suggests that raising common equity is more costly than debt. Reasons for this include the agency costs associated with bank management[15] as well as the information asymmetries on the primary market for shares.[16] And any assumption that tax policies treat debt and equity the same is a frail one. Debt

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[12] As Miller clarifies in Merton H. Miller, 'Do the M&M propositions apply to banks?' (1995) 19 Journal of Banking & Finance pp.483-489.

[13] Anat R. Admati, Peter M. DeMarzo, Martin Hellwig, and Paul Pfleiderer, 'Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity is Not Expensive' (2013) Working Paper No. 2065 <www.gsb.stanford.edu/faculty-research/working-papers/fallacies-irrelevant-facts-myths-discussion-capital-regulation-why> accessed 10/09/2025.

[14] Samuel G. Hanson, Anil K. Kashyap, and Jeremy C. Stein, 'A Macroprudential Approach to Financial Regulation' (2011) 25(1) Journal of Financial Perspectives pp.3-28.

[15] See in particular, Douglas W. Diamond, Raghuram G. Rajan, 'A Theory of Bank Capital' (2000) 55(6) Journal of Finance pp.2431-2465.

[16] See especially, Stewart C. Myers and Nicholas S. Majluf, 'Corporate financing and investment decisions when firms have information that investors do not have' (1984) 13(2) Journal of Financial Economics pp.187-221.

financing is tax-advantageous. In the UK, interest payments on debt are deductible from corporate profits before tax is calculated, whereas dividend payments are not. Consonant with this alternative view, increasing capital requirements for banks could potentially reduce their ability to extend credit and investment.

13. At the level of practice, recent evidence seems to support the alternative view. One study shows that a 1 percentage point rise in bank capital requirements is associated with a 5.7-8% decline in bank lending in the subsequent three quarters.[17] Using UK data from 1989-2011, another study finds that changes in capital requirements do adversely impact lending, with commercial real estate and corporate lending growth showing the largest declines.[18]

What, if any, reforms to bank capital regulation could be implemented to increase the risk appetite of the banking sector to provide lending to the real economy?

14. Post-financial crisis reforms produced capital regulations loaded with ingots of detail, introducing further complexity to an already opaque set of rules.[19] They also continue to have an over-reliance on highly

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[17] Shekhar Aiyar, Charles W. Calomiris, and Tomasz Wieladek, 'Does Macro-Prudential Regulation Leak? Evidence from a UK Policy Experiment' (2014) 46(1) Journal of Money, Credit and Banking pp.181–214.

[18] Jonathan Bridges, David Gregory, Mette Nielsen, Silvia Pezzini, Amar Radia and Marco Spaltro, 'The impact of capital requirements on bank lending' (2014) Bank of England Working Paper No. 486 <www.bankofengland.co.uk/working-paper/2014/the-impact-of-capital-requirements-on-bank-lending> accessed 11/09/2025.

[19] Richard Ridyard, 'Carrots and sticks in bank governance: time for a bigger stick?'

technical models. It is not at all clear why this level of complexity and detail is required. Indeed, misallocation of assets can occur because banks can use this complexity and opacity for their own advantage. As could be observed prior to the financial crisis, banks performed trades that lowered their equity capital levels, and increased their leverage, without contravening the Basel Accords.

15. There is a case for greatly simplifying capital regulation. A simple set of rules, for instance, on tier one capital and core tier one ratios could be maintained. But scaling back other aspects could release banks from the harness, decrease compliance costs, and incentivise banks to increase the provision of lending to the real economy. As it stands, without recasting bank capital regulation, the involvement of NBFIs will only increase. And yet NBFIs, for the most part, are not subject to the levels of regulation banks are.

16. It is also instructive to recognise that in times of crisis, formulaic capital adequacy requirements are unlikely to be effective. This is because by that point, markets tend to demand higher levels of capital than regulators do. What is needed in such circumstances is greater Central Bank discretion in its capacity as lender of last resort.

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