

UK international financial services – the future

A report from UK based financial services leaders to the Government



May 2009

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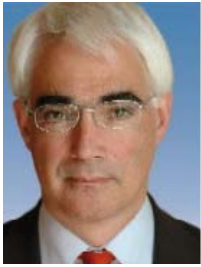
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Forewords



This report looks to the future. I am determined that the financial services industry remains an essential and important part of the global economy. This Group has carried out its work against the backdrop of the most severe global financial crisis in

generations. Global markets around the world have suffered stress and instability, dealing a blow to an already weakened global economy. Governments around the world have provided significant public financing support to restore financial stability.

Here, we took action to address the issues faced by individual institutions, as well as implementing measures to ensure adequate capital and liquidity, deal with impaired assets and to increase lending into the economy.

But, especially now, we must look firmly to the long-term. This report is timely because it aspires to a clear long-term direction, over the next 10 to 15 years, for strengthening and enhancing the UK's important place in the global financial services industry.

I am confident, that the financial services sector should be, and must remain, an important part of the UK and global economy.

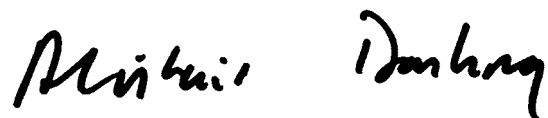
We must work together to learn the lessons, here and internationally, and reform regulation. But we need to distinguish between what has worked, and what needs to be strengthened and improved.

Financial services are critical to the UK's future, but also to the future of emerging economies around the world. This report makes a strong case for Government and industry to approach the sector's long-term growth through genuine partnership – working with the wider economy to foster productivity, while maintaining openness and

a collaborative spirit with emerging economies and their financial centres.

I believe that, embedded in the seeds of economic recovery, will be an ever stronger will by industry and financial centres to compete and to innovate. As this report highlights, increased competitiveness and innovation can be forces for good, by helping to solve everyday problems and giving customers more choice. But we need to remember the consequences of competitiveness for competitiveness's sake – and be in constant vigilance that the financial services sector has a key, and very real, role in serving the wider economy.

We need to look beyond today's problems, and this report takes a valuable step in laying the groundwork for the UK financial service industry's long-term future.



Alistair Darling

Forewords



I was asked in July 2008 by the Chancellor, Alistair Darling, to co-chair with him this group. Our remit was to examine the competitiveness of financial services globally and to develop a framework on which to base policy and initiatives to keep UK financial services competitive over the next 10 to 15 years.

Much has changed recently in financial services, both globally and in the UK. What has not changed is the importance to any economy, not least that of the UK, of industries which are globally competitive.

Market cycles come and go but competition never disappears. Our report sets out recommendations designed to build on the UK's relatively strong position in financial services and its partnership with other economies. We do not seek to recommend the ideal future shape of one of its components, the banking industry, nor does the Report focus on purely domestic financial services, important though they are.

Arguably financial services is one of those industries, like media, pharmaceuticals and biotechnology, and high-end engineering and aerospace, where the UK has a competitive advantage. The professional services associated with the financial sector, such as law, accounting, shipping, and consulting also come to mind. Of course any economy of the size of that of the UK will have a substantial domestic financial services sector. The UK, not just London, additionally has a sizeable international component built on the foundation of tradition, trust, and competence. It is noteworthy that while London is the single largest provider of such services, nearly half of the gross value added in financial services is generated outside London and the Southeast, and more than half of the employment. The cluster effect of London

thus benefits the rest of the UK through high value employment opportunities.

Some of the concern about the present financial and economic crisis has rightly concentrated on banks and their corporate and wholesale activities. However, other components of financial services have remained generally healthy. While the UK financial services sector is not only spread geographically outside London, it also is much more diverse than simply corporate and institutional banking. Well over three quarters of those employed in the sector work outside that part of the industry.

Nor is the proportion of financial services in the UK so high as to warrant concerns about an "unbalanced" economy. Financial services amount to around eight per cent of output in the UK. This is similar to the US and significantly less than in other service-led economies such as Hong Kong and Singapore.

Regulation is an important factor for stability and success. We expect and encourage better regulation and believe that the most important global financial centres, including the UK, benefit from a regulatory framework which is both effective and has high standards. Regulations, particularly banking regulation, will undoubtedly continue to be the subject of thoughtful deliberation following the G20 meeting. There is much to be improved in this area – we believe that the UK has a major role to play in helping set standards – but not everything is broken.

Lord Turner in his Review noted that some of the innovation in financial services has had little social value and that its absence would not be much missed. While we concur broadly with his Review, we think that any industry that does not spend time and resources on research and development will soon wither. Innovation is needed, for example, to address the 'pensions time-bomb', to address climate change, and to develop improved risk management products

and techniques to enhance stability. Additionally, many countries – both developing and developed – have investment needs. Their hunger for capital will require the support of the international markets and the development of new ideas and structures.

We strongly believe that it is the use to which such developments are put that is important, rather than deliberately neglecting innovation. London has generally been at the forefront of developing financial services that do have social value and are widely accepted by users. We expect regulation and self-interest to channel these efforts into areas of activity that support directly social and economic needs.

We are indebted to a number of related reports and reviews which have been prepared in recent months, or are being finalized. We acknowledge their relevance and recommendations. I want to thank their chairmen, their working groups and their authors for their contribution to the debate about the importance of financial and professional services and the continuing vitality of many of their activities. Bob Wigley's Report on London's role as a financial centre makes a number of recommendations which we echo in our report. The Professional Services Global Competitiveness Group, co-chaired by Sir Michael Snyder and Lord Myners focused on the human talent and its availability and development – an area of critical importance to all services. The Turner Review on regulation has already won widespread praise and we look forward to the reports on insurance and fund management from groups co-chaired by the Chancellor with Andrew Moss and Robert Jenkins, respectively. I have maintained close contact with the authors of these reports.

What is significant in all of them is the acknowledgement that the UK is fortunate to possess a financial services sector which stands out in relation to other countries. But as events have shown we cannot be complacent. Apart from the more

immediate and necessary improvement in a number of areas which we highlight in our report, there is the all-important aspect of government and industry co-operation on strategy and implementation which all of the members of our group felt deserved particular attention. I want to thank the Chancellor and the members for their commitment, time and constructive, if not uncritical, views. This report is the result of their work and that of the many individuals listed elsewhere who supported them.

In looking into the future – after all we were tasked to develop a plan for the next ten to fifteen years – we believe strongly that the benefits of the cluster effect in international financial services, so evident in the successful integration of financial services across the UK, can be extended and multiplied through greater partnership with financial centres outside the UK. In that way the UK will benefit and so will the global economy: growth in financial services will not be simply domestic, but increasingly international, with global standards forged from global co-operation.



Sir Winfried Bischoff

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Executive summary

UK International Financial Services – a centre of excellence working in partnership with the world.

Our Group was asked by the Chancellor of the Exchequer to consider how the UK can maintain and develop its international competitiveness in financial services, taking a long-term view. The objective was to propose a framework that would apply to the UK over the next 10 to 15 years. The members of the Group were drawn from across the financial and related professional services industries, to share our diverse experience and speak with personal authority.

This review began as the financial and economic crisis was gathering pace, but had not yet assumed the depth it has today in so many countries around the globe. Even before this crisis the UK was facing a rapidly changing international environment – globalisation of markets, the accelerated growth of emerging economies and profound demographic change – and was having to adjust its medium- to long-term outlook. The challenge has been made more complex as the fiscal and economic costs of the crisis have become clearer. The crisis has also added relevance and urgency to this work; indeed we hope our proposals will form part of the medium-term stabilisation process and contribute to sustainable growth and prosperity. Moreover, the UK's long-term approach to international financial services needs to be sufficiently robust to withstand challenging and volatile conditions, such as those we face today.

The UK is a leading international financial centre. It plays an important role in the efficient flow of capital around the world, including between developed and developing economies. The UK's strengths, historically, have been its open market-based economy, its regulatory, accounting and legal frameworks, its skilled labour force, its critical mass of financial services participants, as well as the use of English as a business language and the relative

long-term stability and predictability of its tax regime. While London is often the point of entry for overseas customers, the clusters of international financial services businesses that have gathered in London's financial district – "The City" – are complemented by the expertise that lies beyond this centre. It is important to acknowledge that the international financial services sector has been a major contributor to the wider UK economy, and we envisage this remaining the case in the future.

The financial services sector includes banking, insurance, asset management, organised and informal markets, and a wide array of supporting professional services. Some myths have gained currency as the crisis has developed – that financial services occupy a disproportionate share of the UK economy, that financial services play little part in the "real" economy beyond London, and that all financial innovation is of little economic or social value. In this Report, we show why the international financial services industry is valuable to the UK. Far from seeking to retrench or rebalance these activities within the UK economy, we urge the Government, the industry and others to reaffirm that it is in the UK's long-term and strategic interests to ensure that – subject to effective regulation and supervision – the financial services sector is improved and strengthened, to maximise its contribution to the UK and to the global economy.

Recent attention has focused mainly on the crisis in the banking sector; it is important, though, to remember that many parts of the sector have performed and continue to perform well. However, we need to look carefully at how financial services as a whole will react to long-term global trends; the major challenges these pose; to the changes brought on by the current banking crisis; and to how the banking sector in particular restructures itself. Corrective actions are being taken. Strengthened banking regulation globally and improved corporate

governance will be key to restoring public confidence in this key area. International financial services regulation should, by definition, be coordinated internationally.

The central theme of our Report is this: the UK's future success must be based on partnership: between the financial services industry and the wider domestic economy; and between the UK, emerging economies and their financial centres.

It is not the aim of the Report – nor have we tried – to recommend a lengthy list of detailed measures. The considerations outlined here provide general policy guidance for the longer term, while a number of more specific actions that we propose should be undertaken over the medium term.

In summary, we recommend that the Government and the industry should:

1. Establish a clear direction for the UK international financial services industry in partnership with the wider economy and overseas markets

- a. Ensuring that the benefits of the UK's position as an international financial centre continues to accrue broadly across the UK domestic economy.
- b. Recognising that the UK's status as an international financial centre depends on the maintenance of an open economy and cooperation with other financial centres.

2. Reaffirm the UK's reputation for competence, responsibility and trustworthiness

- a. Taking a leading role in the formulation and implementation of global and EU regulation. An effective regulatory structure, which appropriately distinguishes between different parts of the financial services sector, should be seen as a competitive advantage to be retained. We should

reinforce the attractions of the UK as a home from home for international financial firms and investors.

- b. Generating strong and purposeful engagement between the Government and the industry to ensure that the UK tax system remains stable, sustainable and competitive in the long term.
- c. Supporting flexible labour markets, with enhanced skills and training.
- d. Innovating responsibly with effective oversight to meet the challenges of the next 10 to 15 years.

3. Ensure effective delivery of these recommendations

- a. Building on and enhancing the close and productive dialogue between the Government and the industry.
- b. Effectively promoting the UK's international financial and professional services capabilities.

On this basis the financial services sector will continue to play a key role in the growth and employment prospects of the UK, and enhance international growth and stability. Over the next 10 to 15 years the shape of the global financial services sector will change considerably. What is currently developing will become mainstream. We will see new major financial services firms growing out of the emerging economies; small-scale innovative financial markets – such as carbon markets – will achieve critical mass; the number of world class financial centres will grow. This is our response to these challenges.

1. Establish a clear direction for the UK international financial services industry to partner with the wider economy and overseas markets.

Consideration	How
<p>a. To ensure that the benefits of the UK's position as an international financial centre continue to accrue broadly across the UK domestic economy.</p>	<ul style="list-style-type: none"> – The Government and the industry should lead an informed public debate on the role of financial services in the economy, to explain the depth and breadth of the sector and its existing and potential contributions to the wider economy. – Public authorities across the country should work with the industry to strengthen involvement in the regional provision of international financial services by the financial and professional sectors. – The Government and the industry should enhance the links between regional professional services firms and financial centres to generate business, to use the wider skills base and to reduce costs.
<p>b. To recognise that the UK's status as an international financial centre depends on the maintenance of an open economy and cooperation with other financial centres.</p>	<ul style="list-style-type: none"> – The Government and the industry should collaborate in order to maintain and expand the UK's central role as a finance portal for the rest of Europe and the world, supporting other financial centres as they develop their own capabilities and making the UK a central source of liquidity and expertise for other financial centres. – The Government and the industry should support financial markets infrastructure initiatives, especially clearing and central counterparties for traded products. – The Government and the industry must intensify work with emerging market economies, through strengthened economic and financial policy dialogue, the creation of joint ventures, co-investment and training and shadowing schemes to support them in building local capabilities – as well as through sharing experiences on regulation and business models in relation to primary exchange structure and risk management.

2. Reaffirm the UK's reputation for competence, responsibility and trustworthiness.

Consideration	How
<p>While recognising the UK's strong reputation in financial and professional services, it is clear that the present financial crisis has challenged public perceptions of the UK's banking sector and highlighted the need to strengthen the UK's regulatory reputation. Good faith and trust must sit at the heart of the financial services business.</p>	<ul style="list-style-type: none"> – The Government and the industry should restore public trust by addressing the deficiencies which have been revealed by the banking crisis, and rebuild the reputation of banking. – The UK must play an active role in regulatory leadership: future success depends on the creation of – and adherence to – high standards. – There should be openness in sharing regulatory insights and in industry and regulatory exchanges with other countries and regions. – The Government should encourage collaboration among financial practitioners and work together with the industry to ensure critical initiatives are not missed.

Our medium-term recommendations mainly address the banking sector, as this is where the countries that belong to the G20 and regulators in the UK, EU and US are currently focused. Other sectors face some similar issues (such as the need to avoid actions that amplify the economic cycle), but remedies that are appropriate for banking may not be applicable to them. Beyond the overarching considerations noted above, the UK's reputation and the economic and social value of financial services depend on four conditions for success: regulation, tax, skills and an innovative environment – as set out below in 2a to 2d.

2a: Take a leading role in the formulation and implementation of global and EU regulation.

Consideration	How
<p>The UK has a strategic interest in the formulation of high international standards, and must take a leading role in the formulation and implementation of global and EU regulatory standards.</p>	<ul style="list-style-type: none"> – International standards should be consistently and rigorously implemented in regional and national rules; the fragmented international supervisory landscape is a particular challenge in both insurance and banking. – Any rules and proposals that are specifically designed for the UK must recognise the international context of the UK's financial sector. – Supervisory and regulatory measures taken to respond to the current economic crisis need to distinguish between, and be proportionate to, the experience of different financial services sectors. – Honest diagnosis is required to distinguish between policy and implementation: failure in implementation does not mean the policy is wrong, and bad policy cannot be corrected by implementation.
<p>To periodically review regulatory structures.</p>	<ul style="list-style-type: none"> – The UK should take a leading role in the EU debate on new regulatory architecture. – The operation of the Tripartite system should be regularly reviewed and tested to ensure that it operates efficiently and effectively. – There needs to be more understanding of the interaction between financial regulation and accounting standards. – The “precautionary principle” should be applied to all rule-making efforts, and all changes should be subject to impact assessment, progress reviews and a periodic check of whether the policy continues to be appropriate. – Existing principles, rules and practices should only be replaced with proper justification (that is, in line with the better regulation prescription for effective policy).
<p>To agree standards for crisis resolution at the global and regional level.</p>	<ul style="list-style-type: none"> – As an international financial centre, the UK needs to be able to resolve future problems and to put better crisis resolution mechanisms in place. – The UK must take decisive action to strengthen its insolvency regime in order to address some of the difficulties revealed by the failure of Lehman Brothers. International cooperation will also be critical in dealing with the insolvency of cross-border firms.

2b: Generate strong and purposeful engagement between the Government and the industry to ensure that the UK tax system remains stable, sustainable and competitive in the long term.

Consideration	How
<p>To generate strong engagement between the Government and the industry, in order to ensure that the UK tax system remains stable, sustainable and competitive in the long term.</p>	<ul style="list-style-type: none"> – The Government and the industry recognise the importance of moving away from binary discussion on tax rates (“lower at all costs”) and support continued efforts by multinational companies to work with the Government to achieve a transparent, predictable and modern UK tax system that also recognises the competitive challenges of the international tax environment. – Taxation policy should be mindful of the wider aim of maintaining and expanding the UK’s central role as a financial centre (see 1b). – The Government and the industry must work together to support fiscal consolidation, and to manage tensions between the need to maintain fiscal stability and ensure the tax system can respond to important market trends and the needs of the wider economy. The tax system must be able to respond to circumstances, including the impact of the financial crisis. However, the ultimate objective is delivery of long-term stability and predictability in the UK tax regime.

2c: Support flexible labour markets, and enhanced skills and training.

Consideration	How
To ensure that a robust skills base exists for financial services.	<ul style="list-style-type: none"> – The industry should work with the Government to assess the likely size and skills profile of the financial services workforce over the medium term, focusing on: <ul style="list-style-type: none"> – Skills critical to financial services and those areas where shortages are expected – especially legal, analytical, statistical, information technology, risk and management (many related to the “STEM” skills - science, technology, engineering and mathematics). – Management and other skills critical to international financial services – leadership and management, change management, languages. – Regulatory and compliance knowledge, training and skills. – The value of UK and international professional qualifications should be highlighted.
To build thought-leadership and skills in the current workforce and among graduates.	<ul style="list-style-type: none"> – Industry, government, regulators and academia should increase secondments and exchanges between themselves. – Industry should commit financial or in-kind support for students and academic institutions to help with investment in teaching and research facilities. – Opportunities for partnership with other financial centres should be developed, including links between UK and international universities. – A programme of “continuing professional development” – as in the legal sector - should be considered for wholesale financial services.
To support financial literacy and future financial skills through general education policy.	<ul style="list-style-type: none"> – Support curriculum modules on financial literacy – The Government and the industry should further encourage the teaching of science and mathematical subjects – The industry and education authorities should form partnerships to provide on-the-job skills training
To encourage overseas talent.	<ul style="list-style-type: none"> – The Government should make a commitment to sustaining the UK’s reputation as a world-leading centre where international financial services professionals can pursue their careers. – The Government should ensure that the immigration points system can attract people with scarce financial services skills, including overseas students keen to pursue financial services careers in the UK after graduation. – The Government should introduce work permit categories to recognise scarce professional services skills, as advocated by the report on the competitiveness of professional services.¹

¹ HM Treasury *Professional Services Global Competitiveness Report*, March 2009.

2d: Innovate responsibly with effective oversight to meet the challenges of the next 10 to 15 years.

Consideration	How
<p>To ensure that UK financial services can remain at the forefront of finding new solutions to emerging financial needs and markets – for example financing retirement, healthcare, clean energy, infrastructure development and a wide range of entities requiring capital, from small and medium enterprise to developing economies.</p>	<ul style="list-style-type: none"> – The Government should ensure that regulatory and other initiatives promote the UK as a location for financial markets, and that it keeps pace with the needs of those markets. – Industry associations and business links to academia should be used to complement the strategic efforts of individual firms in focusing on these goals and developing new financial instruments. – The industry should invest in financial infrastructure to support international financial services – in particular in clearing and central counterparties for traded markets. – The appropriate authorities must ensure that technology infrastructure – including power, communications and IT server and network capacity – can support growth in financial services.
<p>To allow responsible financial innovation with effective oversight.</p>	<ul style="list-style-type: none"> – Regulation should not stifle responsible financial innovation, but should encourage research and development within a framework that ensures its suitability before penetration of a new product becomes widespread. – Regulators and the industry must ensure robust risk management of new products and processes by examining the impact on consumers and investors (conduct of business regulation); the appropriate accounting and risk recognition of transactions (prudential supervision); and the potential systemic implications of new products (financial stability). – Where intervention is desired because of risks or client concerns, we encourage the Government and regulators to seek European and global coordination. – The UK must ensure that remuneration structures, policies and governance are adapted to eliminate inappropriate incentives by aligning with the guidelines already published by the Financial Services Authority, the Financial Stability Board and the Institute of International Finance. – UK financial institutions, supported by the work of the Walker Review,² must strengthen their corporate governance focus on risk-related organisational structures and processes.

² Independent review of corporate governance of the UK banking industry, announced 9 February 2009.

3. To ensure effective delivery.

Consideration	How
<p>a. To create a new structure to consider strategic issues and develop a more productive and targeted dialogue between the Government, the industry and other market participants on the long-term strategic development of the UK-based international financial services sector.</p>	<ul style="list-style-type: none"> – The strategic and operational aims proposed by this Report should be considered alongside the findings of the reports by professional services,³ insurance and asset management groups and the review of the competitiveness of London’s financial centre,⁴ and be reflected in the future agenda of Government-industry engagement on the financial and professional services sectors. – The Government should re-orient the objectives, structure and membership of the Chancellor’s High-Level Group to develop a leaner forum led by the Government that focuses on the overall strategic direction of the UK financial services industry, with links to bodies that can play a role in implementing the strategy. – The strategy should be outward-facing and take account of concurrent initiatives in other markets and jurisdictions, including the US and EU.
<p>b. To ensure that efforts to promote the strengths of the UK-based international financial services industry are effective and inclusive.</p>	<ul style="list-style-type: none"> – Organisations engaged in promotional work should operate with clear objectives, representative membership, high governance and professional standards, and a strong awareness of the views and needs of the UK’s wider corporate community and users of international financial services. – The Government, the industry and organisations engaging in promotional work should consider a process of rationalisation and consolidation to reduce duplication, to ensure that promotional resources from the private and public sectors are eventually focused on a single body. – Industry firms that contribute in-kind resources or subscription fees to promotional organisations should play a stronger critical function in the work of these organisations.
<p>To create a more efficient structure to consider promotional issues.</p>	<ul style="list-style-type: none"> – The Government and the industry should support work under way to establish an independent body that is permanent, practitioner-led, politically neutral, strategic and cross-sectoral. – In the UK, the body would work to demonstrate the importance of the financial services industry to a broader domestic audience. – Overseas, it would explain and market the strengths of the UK-based financial services industry. – In relation to the EU, it would work closely with trade associations and others interested in EU developments.

³ HM Treasury *Professional Services Global Competitiveness Report*, March 2009.

⁴ London: *Winning in a Changing World – Review of the Competitiveness of London’s Financial Centre*, December 2008.

Background

1. A changing backdrop

Sustained global economic growth over the last two decades brought with it a massive expansion in financial services around the world. The UK benefited more than most, as London became an increasingly important international financial centre, more recently heading the international rankings.⁵ However, the current crisis has revealed that this sustained period of global growth allowed a number of problems to develop, that particularly affected banking: fiscal and trade imbalances, loose monetary policy, poor governance and management, and inadequate regulatory rules and supervision. As a result, confidence in certain parts of the financial services industry has been replaced in a very short time by fear and uncertainty.

The crisis has been global in nature and affected international financial centres in many countries. This report will not attempt to recount what went wrong, except to note that the recent Turner Review⁶ and HM Treasury's Budget 2009⁷ have set out very clear accounts of the issues. Figure 1 illustrates how the banking crisis evolved, through the interplay of a complex series of factors. Many responses are now being contemplated that could substantially change the financial world. The UK needs to consider these responses – and this Report is intended to be an important part of that process.

We have focused on financial services as a whole, and on what the Government and the financial services industry need to do to maintain the UK's longer-term position. However, various sectors of the financial services industry have been affected quite differently by the crisis. In some – wholesale and investment banking and trading, for example – the results have been extremely serious, particularly in terms of the impact on the global economy, taxpayers and the public finances. This has had some knock-on effect on the insurance and asset management industries, with parts of these sectors having been more affected than others, in some cases limited to a specific group of firms or activities.

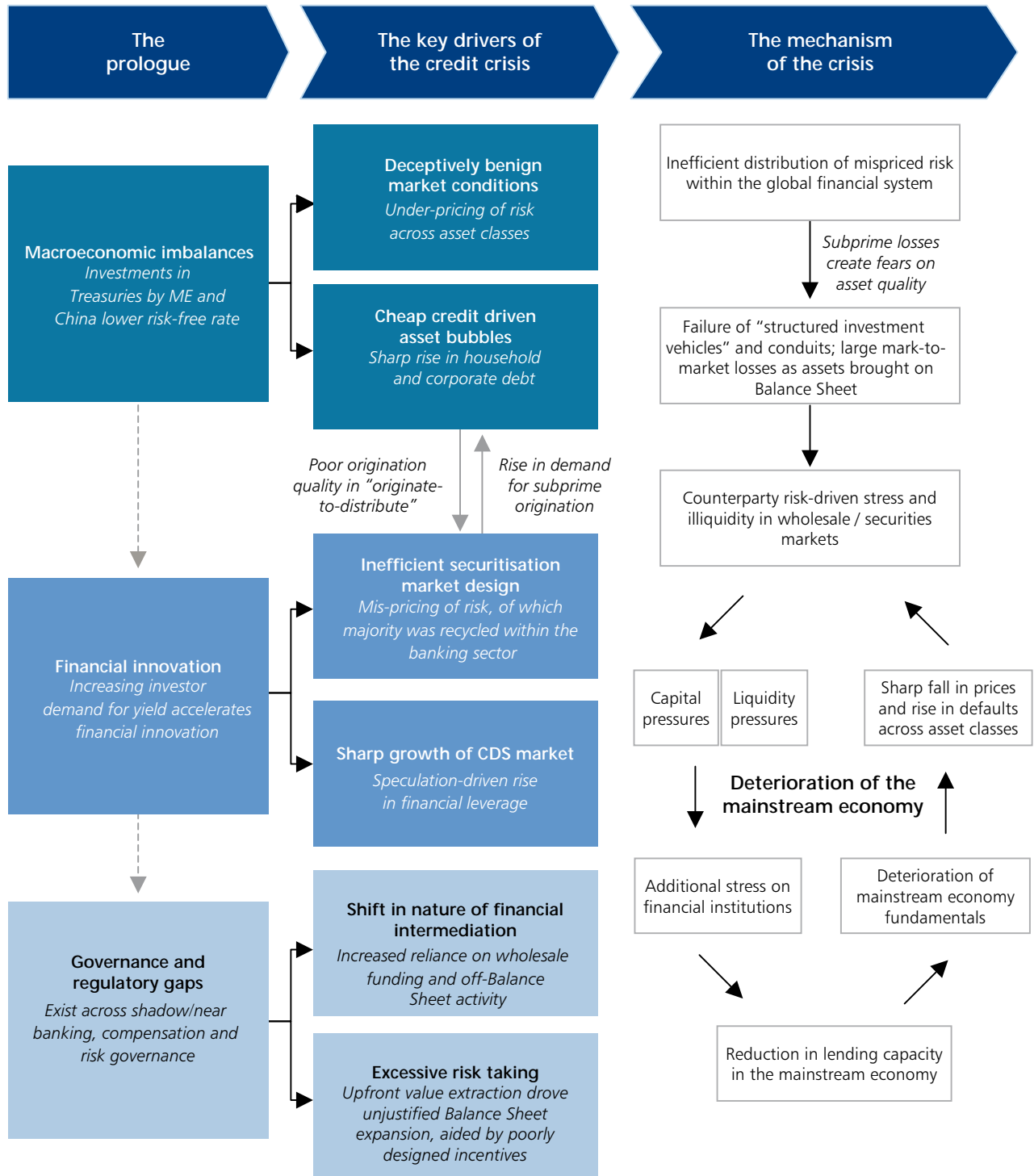
Despite this, the UK continues to meet international demand for many types of financial services, including the issue of bonds, reinsurance of high-value risks and investment of sovereign wealth funds.

⁵ City of London Corporation: *Global Financial Centres Index*, March 2009.

⁶ Financial Services Authority: *The Turner Review: A regulatory response to the global banking crisis*, March 2009.

⁷ HM Treasury: *Budget 2009 – Building Britain's Future*, April 2009. http://www.hm-treasury.gov.uk/d/Budget2009/bud09_complereport_2520.pdf

Figure 1: How the banking crisis evolved⁸



8 Based on Lord Turner's analysis (speech at *The Economist*, January 2009), with Citi, Oliver Wyman additional analysis

The global banking industry has been harder hit for several reasons, including poor appreciation and management of risk, over-ambitious strategies and the development of some new products that proved of minimal economic value. There have been shortcomings in other areas which have led to efforts in all countries to comprehensively review or revise regulation, economic and monetary policy. Serious lessons are being learned by banking executives, central bankers, regulators and supervisors. We believe that if the Government and the financial services industry can continue to work together in learning from those mistakes and shortcomings. Financial services will have a crucial role to play in aiding the recovery: indeed, the revival of credit, liquidity and other financial services should help the economy emerge from recession sooner.

In drawing up our recommendations, we have looked at the interplay of three powerful forces that are reshaping the world economy:

- The globalisation of markets – including in financial services. Figure 2 demonstrates just how sustained the progress of globalisation has been for the last two decades, with a surge in international trade since 2000 and growing interdependence of capital markets. Global trade and financial flows are closely linked. The current crisis has slowed the integration of the global economy and rekindled protectionist tendencies, which could conceivably lead to the return of exchange controls and other current account barriers. But the commitment by the London Summit of the G20 countries on 2 April 2009 to resist such tendencies should, and must, help preserve an open global economy – with globalisation continuing to develop, albeit at a reduced pace in the immediate future. In other words, the globalised world is here to stay.
- The growth of the emerging economies. As Figure 2 notes, they will continue to grow at a faster rate than the economies of the advanced countries for the foreseeable future, accounting for an increasing proportion of global output. This will lead to dramatic changes, including the rise of

local and regional capital markets and increasing economic influence for the largest and most politically stable emerging markets.

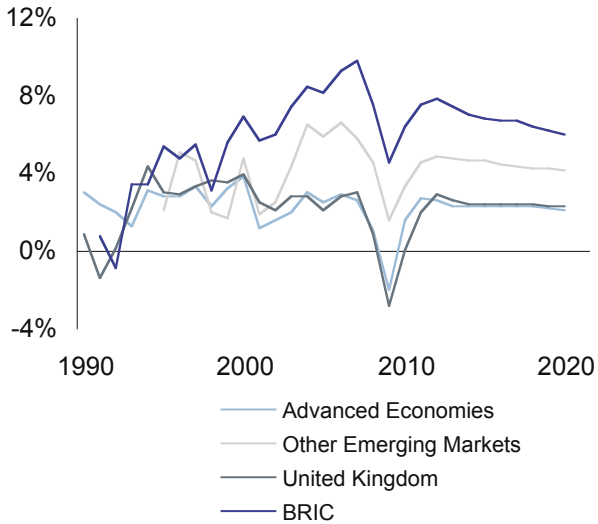
- Demographic change – the so-called “pensions time-bomb”. The demographic profile of emerging economies, whose populations are on average younger than those of developed countries and growing more rapidly, means the influx of new workers into the world economy is set to continue for several decades. By contrast the developed economies will see their active labour forces either grow more slowly, as in the UK, or actually decline, as in Italy, Germany and Japan. The presence of an ageing population with potentially much higher rates of economic dependency has profound implications for global savings and investment balances. Emerging countries will increasingly need longer-term savings products geared towards their changing demographic profile, as well as domestic financial markets with access to international capital pools that can meet their investment needs.

These trends will deeply influence how cash and capital flows are channelled around the world. As a leading international financial centre and an acknowledged centre of investment expertise, the UK has an important role to play in this new environment. Preserving and developing its status as a leading international financial centre requires both private-sector and public-sector institutions to adapt to the demands of a rapidly changing world economy.

Figure 2: The global economic picture⁹

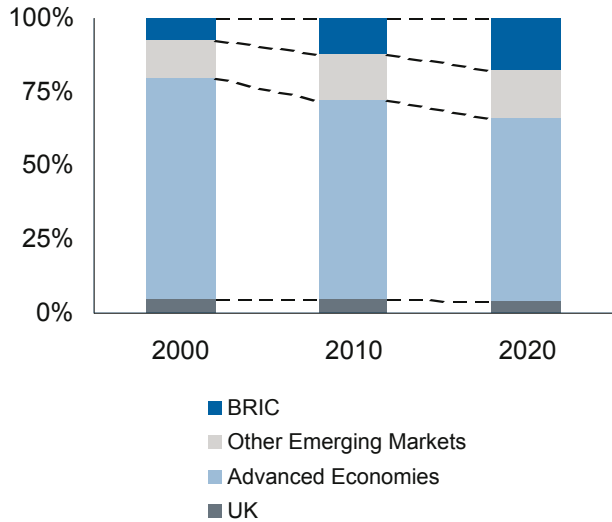
Emerging markets are projected to grow at a faster rate than advanced economies...

Real GDP growth rates, 1990-2020 (January forecasts)



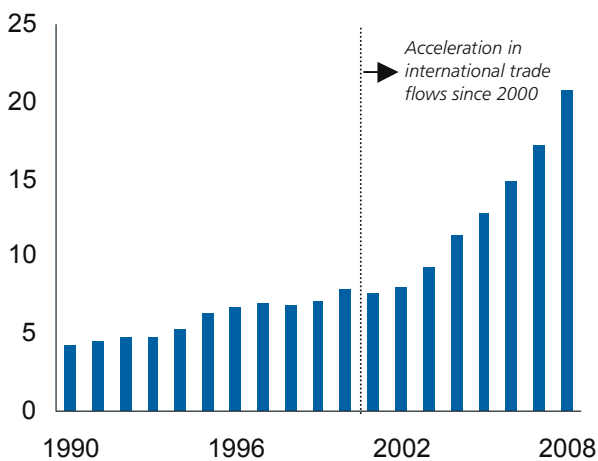
... and will account for at least 35% of global GDP by 2020

Share of global real GDP, 2000-2020



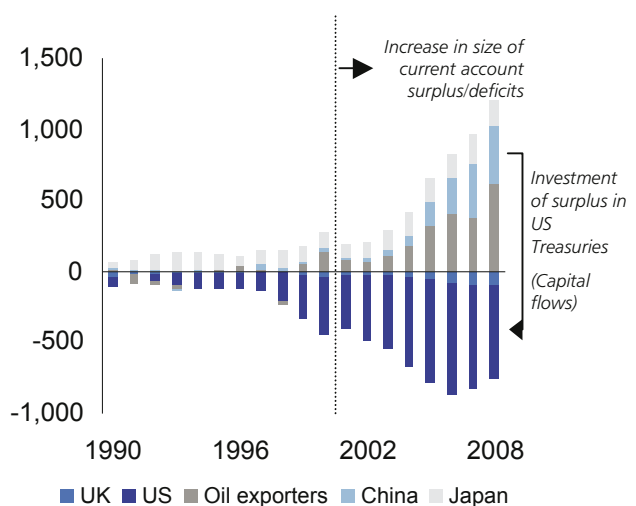
International trade has grown rapidly during this decade...

Global trade of goods and services, 1990-2008 (trillion USD)



... leading to current account imbalances, which in turn have driven global capital interdependence

Current account balances of select economies, 1990-2008 (billion USD)



9 Global Insight, January 2009; IMF: World Economic Outlook, October 2008.

2. Financial services and the UK

The financial services industry plays a vital role in the UK economy. More than one million people work for it, adding economic value per head that is more than double the UK average. The industry accounts for around 8 per cent of output, and is responsible for contributing almost 14 per cent of the tax collected – financing much-needed public services.¹⁰ Financial services is one of the key sectors where the UK retains a distinct comparative advantage – along with other knowledge-driven industries such as information technology, biotechnology, pharmaceuticals, aerospace, sophisticated engineering and media.¹¹ Moreover, it supplies these other high-value industries with the financial services they need to be successful. And it contributes to the UK balance of payments by exporting services and products that have helped develop and change the international economy, stimulating globalisation and bringing hundreds of millions of people into the global market economy.

Many commentators assume that financial services are overwhelmingly concentrated in London and the South East, yet most jobs in the industry are in the other regions – as Figure 3 shows. London is home to just under one-third of overall UK financial services jobs, with the South East region generating a further 11 per cent and the North West almost 10 per cent. Regions better-known for their expertise in engineering and technology also have financial sector output nearing the national average – for example Yorkshire and Humberside with 6.4 per cent.¹²

London's success as an international financial centre relies on expertise in the regions, which are often locations for processing centres, customer

support functions and associated services such as the legal profession and consultancy – as well as some head office activities and strategic advisory functions. Financial centres outside London have developed their own specialities, such as Edinburgh's internationally recognised expertise in asset management. Leeds has combined its strengths in professional services with finance, and is – together with neighbouring cities like York – tapping into a wider business services market.

A regional example is provided by the South West which hosts a wide range of firms employing many thousands of individuals across the financial services spectrum. They include large insurers such as Axa, Bupa and Liverpool Victoria based in Bristol and Bournemouth, significant back-office administration providers like Capita with a significant presence in Gloucester and Exeter, private client managers such as St. James's Place in Cirencester, and large parts of Lloyds Banking Group in Newport, Bristol and Gloucester.

These local "clusters" effectively support the main international financial services centres and allow the UK regions to offer their expertise to a wider global market.¹³

A myth that has emerged in the current crisis is that the UK has an unbalanced economy – especially in comparison with other countries. In fact, the contribution of financial services to the UK economy has fluctuated in a band of 5-8 per cent of output over the past decade. This is similar to the USA, comparable EU economies such as the Netherlands, and significantly less than other modern service-led economies such as Singapore and Hong Kong. It is also much less than the share of output of manufacturing which, at just under 14 per cent of gross domestic product, is wrongly thought to have been marginalised by financial services.¹⁴

10 Estimate for the proportion of the economy made up by the financial services industry are difficult to resolve due to the effects of "financial intermediation services indirectly measured". These have historically been excluded from the National Accounts, but are now in the process of being incorporated. Estimates for the Financial Services contribution range between 7.5 per cent and 10.8 per cent. Office for National Statistics: *United Kingdom National Accounts: The Blue Book*, 2008.

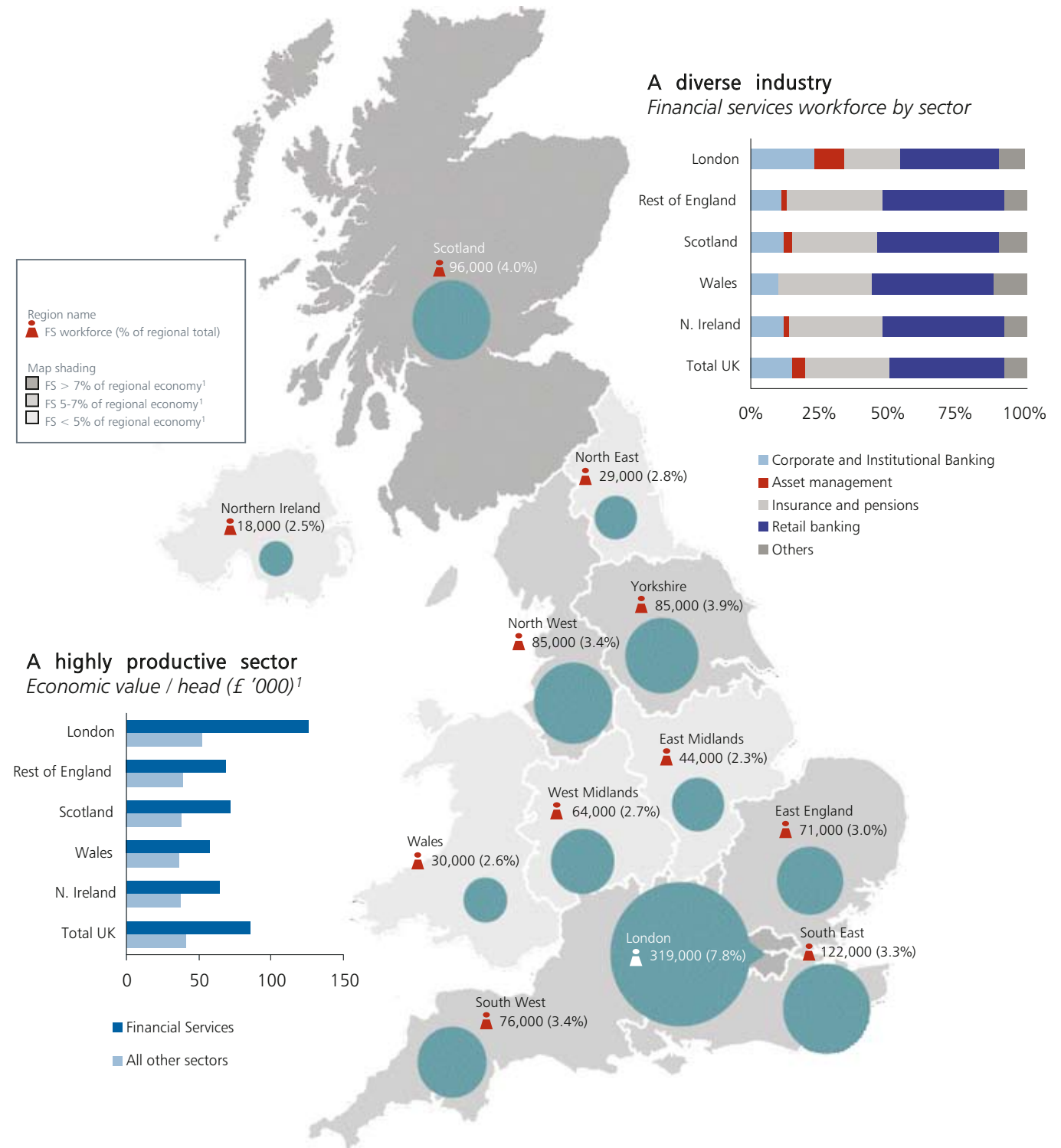
11 See HM Government: *New Industry, New Jobs – Building Britain's Future*, April 2009. <http://www.berr.gov.uk/files/file51023.pdf>

12 International Financial Services London (IFSL): *Economic Contribution of UK Financial Services 2008*.

13 Brown, Hannah: *UK Cities in the Global Economy*, Centre for Cities, September 2008, p12, <http://www.centreforcities.org/index.php?id=574>

14 UK Office for National Statistics, US Government, Hong Kong Department of Census and Statistics, Singapore Department of Statistics.

Figure 3: The UK financial services industry employs over one million people¹⁵



¹ Defined in terms of Gross Value Added

¹⁵ Sources: Annual Business Enquiry (ABI); Office for National Statistics (ONS); British Bankers' Association (BBA); ABI; Mercer Global Investment Manager (GimD) database; Oliver Wyman analysis

There are additionally, multiple connections between finance and the non-financial economy, as Figure 4 outlines – connections that are strengthened by the industry’s links with international markets. The financial sector supports individuals and businesses in four core areas:

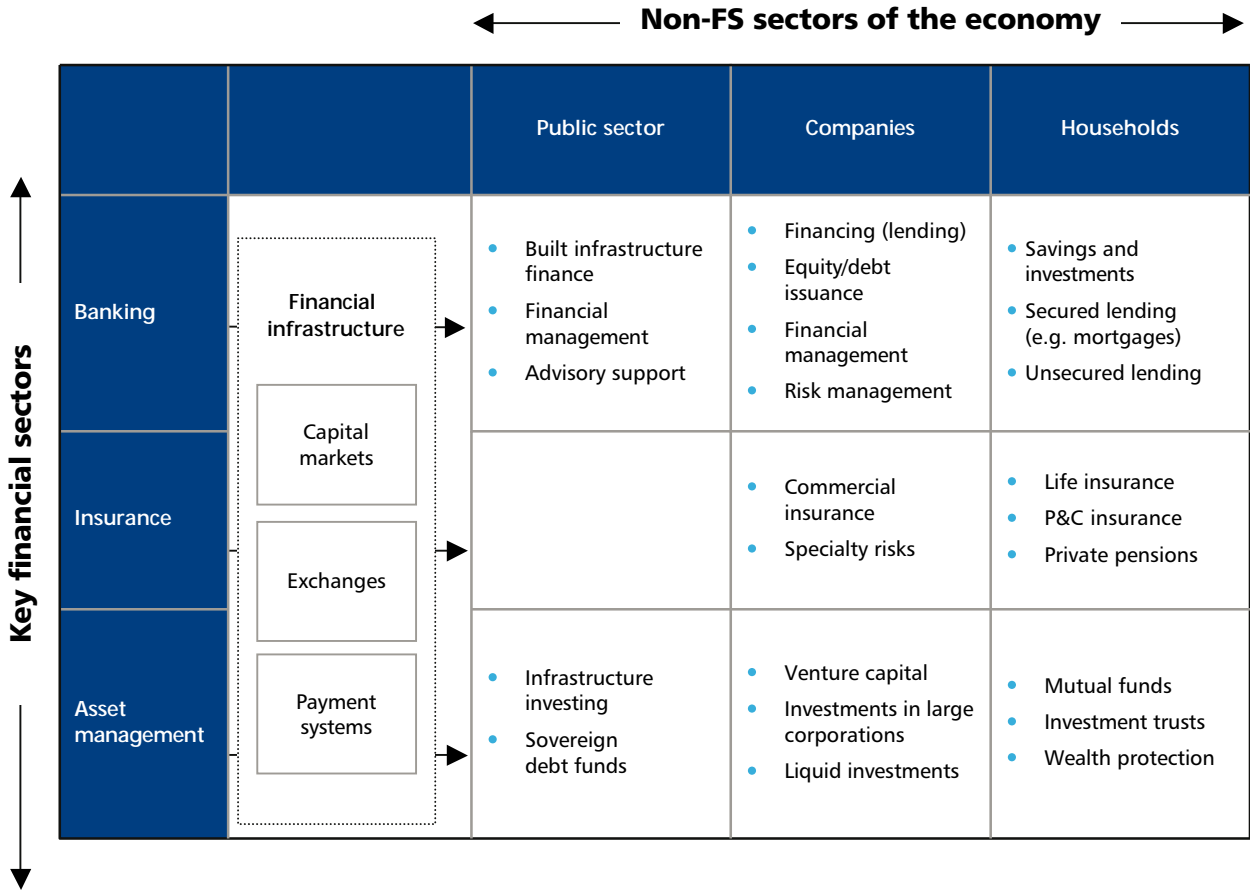
- Banking – to provide finance for individuals, households, business and government. The UK banking sector’s international links have in more normal times provided direct access to the global capital market, with the UK consistently the second biggest recipient of capital inflows in the developed world after the US - much of which has come in the form of international bank lending and foreign direct investment. Competition helped to boost the supply of finance and reduce lending margins, as has been highlighted by the temporary contraction in this source of funding.
- Insurance – to help businesses and households manage their risks effectively. Again, the international reach of UK-based insurers helps maintain competitive premiums, with large economies of scale and strong competition. London’s international reinsurance strengths provide access to a wide range of risk management policies, including protection against fraud, piracy, freak weather and loss of or damage to very valuable items.
- Investments – allowing society to accumulate wealth and manage risk. The UK pension and investment sectors are broad and highly competitive, largely because the domestic providers are already closely linked to international financial services markets, providing a greater diversity of investment opportunities.
- Financial infrastructure – payments systems and other types of financial services infrastructure provide the mechanisms through which businesses and households can carry out transactions quickly, cheaply and reliably. This financial “plumbing” is vital to the national economy, for government and public services, for companies – whether international or domestic – and for citizens. The architecture of these systems such as payments, clearing and settlement of

financial transactions is often international, bringing lower costs and wider access through a global network.

Commentators have discussed returning financial services to a “narrower” model – for example, by separating the traditional banking model from a more market-driven investment banking model, or restricting insurance to a narrower range of risks. The desire is to reduce the danger of one type of activity spilling over into another to the detriment of customers, but the risk is that the ability of the industry to find solutions to future economic and social problems would be undermined. The provision of housing finance for individuals today or pensions for tomorrow, or of insurance against potential risks for businesses or finance at cost-effective rates for their expansion might require the synergies of the combined models.

An industry constrained on narrow lines would find it harder to develop new products that can be beneficial to customers and to society. Moreover, it can be argued that appropriately supervised broad-based banking institutions which serve complex global businesses have the potential to enhance overall financial stability through risk diversification and the ability to balance investments with deposits.

Figure 4: How financial services support the rest of the UK economy¹⁶



¹⁶ Citi, Oliver Wyman analysis

Case study: Private equity and the UK economy

The rapid development of the UK private equity industry over the past two decades shows the multiplier effect at work for the financial sector value-chain and the wider UK economy. According to a study by the British Venture Capital Association (BVCA), for every private equity executive investing directly in UK companies, 2.3 full-time jobs are created, mainly within the corporate finance and accounting sectors to provide specialist advice and other services.¹⁷ Other supporting industries such as management consultancies (which undertake due diligence on transactions) and legal services are in turn supported by their own network of service providers. The UK private equity industry has generated a positive net inflow of capital into the UK, with 67 per cent of total capital invested over the past six years committed to UK-based companies.

¹⁷ BVCA: *Private Equity's Impact as a Financial Service*, February 2007 <http://www.bvcaweb.co.uk/doc.php?id=587>

This report does not argue that the financial services industry is a “special case”, nor does it suggest that the driving forces in the industry are anything other than commercial interests. But it does maintain that financial services are an important part of the UK economy, and that their contribution is strengthened by their leading international role.

3. UK international financial services and the global economy

UK-based international financial services play a vital role in the global economy. This is an industry in which the UK has built a world-class reputation, and which other countries look to for guidance when developing their own financial services industries.

As Figure 5 underlines, the UK industry is a global market leader in many categories of financial business:

- London is a global centre for international bank funding and has a significant share of the business of raising debt funding through the wholesale markets;
- UK trading floors account for a major share of foreign exchange trading, as well as leading positions in equity, bond and commodities trading;
- the UK's financial exchanges have been used to raise capital at both the initial and follow-on listing stage by many foreign companies;¹⁸
- sovereign wealth funds from the Middle East and Asia, private banking clients from around the world and fund managers from other financial centres such as Johannesburg, Toronto and Sydney choose UK-based firms to manage their assets;
- the UK is a major insurance hub, whose concentration of skills includes the underwriting capabilities of Lloyd's of London, the investment expertise of London and Edinburgh and the insurance support services provided in Cardiff, Glasgow and other regional cities; and
- London has acted as a centre for developing products in the wider international system, from interest-rate derivatives, to carbon permit trading and Islamic finance.

One key reason why so much financial services business flows through the UK is that it offers a full range of expertise in sectors such as investment management, insurance and capital markets. This clustering, in a English-speaking country located between the American and Asian markets, enables capital to be efficiently allocated around the world – providing benefits well beyond the UK's borders.

A second – often-underplayed – UK strength derives from its role as the European Union's leading financial centre, supporting other European centres and the wider EU economy. The UK is an important provider of financial services for European companies, and has also influenced financial regulation in the single European market to the benefit of consumers and businesses throughout the EU.

Third, the UK is home to a globally leading professional and business services sector aligned to the financial services industry. Some of the world's

¹⁸ This includes smaller companies attracted by the Alternative Investment Market (AIM).

largest legal and accountancy firms have their global or regional headquarters in the country. The English legal system, with its reputation for fair dispute arbitration, impartial civil courts and readily enforceable rulings, has become the contract law of choice globally.¹⁹

Recent decades have seen a reshaping of the global financial system, with the growth of new regional financial centres such as Shanghai, Mumbai and Dubai. Japan's long economic recession has reduced Tokyo's role as Asia's leading financial centre. New York, focal point of the world's largest economy, remains a major international financial centre – as does London because of the continuing strength of its international business.

How did the UK arrive at its current position? Situated as it is in a sizable domestic economy, Britain's international financial focus began when it funded the significant expansion of trade beyond Europe. In the 19th century, the country's financial institutions changed focus to encourage UK manufacturing and to facilitate trade in its products. In the 1970s the UK became a key centre for recycling petro-dollars, before liberalising its financial markets in the "Big Bang" of 1986. The fact that finance is as important as ever demonstrates the UK and London's enduring ability for reinvention in the face of changing demand and worldwide wealth patterns.

Other financial centres have at times fallen victim to introspection, or have struggled to put in place appropriate legal, regulatory and tax frameworks. The open UK economy, in contrast, has been quick to adapt, to attract international business with a well-developed and clear institutional framework and to maintain a deep pool of skilled workers. The challenge now is to preserve those benefits while guarding more effectively against the severe damage that financial crises and other sources of volatility can cause.

¹⁹ HM Treasury: *Professional Services Global Competitiveness Report*, March 2009.

Case study: Why foreign companies list in London

The shares of more than 3,300 companies are traded on the various markets operated by the London Stock Exchange, from some of the world's biggest multinationals on the blue chip FTSE 100 index, to earlier stage companies quoted on AIM, the international growth market for smaller companies. The majority are UK-registered or with significant assets and operations in the UK, but London also acts as a magnet for international companies – over 650 from 72 different countries. This gives UK-based domestic and international investors opportunities to participate directly in growing economies around the world.

There are several specific factors that attract business to London:

- the large pool of investment funds managed out of London;
- the large number of professional institutional investors based in the UK who manage funds on behalf of investors around the world;
- the lower costs of capital for companies issuing shares²⁰ – a result of the deep pool of funds and efficient market structures;
- the broad range of analysts based in London who will be familiar with international companies across a wide range of industrial sectors; and
- the high quality business and support services - for example, four out of six of the world's biggest law firms have headquarters in London.

In a recent survey looking at the attributes of 50 different centres of commerce,²¹ London performed well against several measures: economic stability, ease of doing business, volume of financial flows, importance as a business centre, and knowledge creation and information flow.

Companies and investors choose London because of the effective approach taken to equity market regulation and corporate governance. London sets best practice in disclosure and transparency and, by coming to London, companies and investors will be associated with high standards. The UK's corporate governance regime also scores well with investors and regularly comes at the top of international surveys.

For example, the Fresnillo Group is the world's largest primary silver producer and Mexico's second largest gold producer. In May 2008 it became the first company from Mexico to list on the London Stock Exchange's Main Market. Market capitalisation at admission was \$7.7bn and the company raised \$1.7bn, of which 18 per cent came from North American investors - demonstrating the international attraction of companies listed in London. Fresnillo chose to list in London because it is a key international mining finance centre with a strong understanding of the industry.²²

The alternative to the Main Market is the Alternative Investment Market (AIM), which allows smaller and growing companies to access investment capital. This model of capital-raising has proved attractive to other countries. For example, the London Stock Exchange and the Tokyo Stock Exchange (TSE) announced a joint venture in 2008 to establish Tokyo AIM, a new market in Japan that required legislative change. The partnership brings together the London Stock Exchange's experience of building the world's leading growth market with TSE's infrastructure and local expertise. Tokyo AIM is expected to emulate the UK experience of creating a multiplier effect in the wider Japanese economy as growing companies raise capital, and Japanese domestic investment funds begin to invest in the new opportunities created by Tokyo AIM companies.

²⁰ Sources: Bloomberg: underwriting fees for initial public offerings in London are approximately half those of the US. London Stock Exchange: fees to be admitted to trading on London Stock Exchange markets are a tenth of US fees and a third of Asian fees.

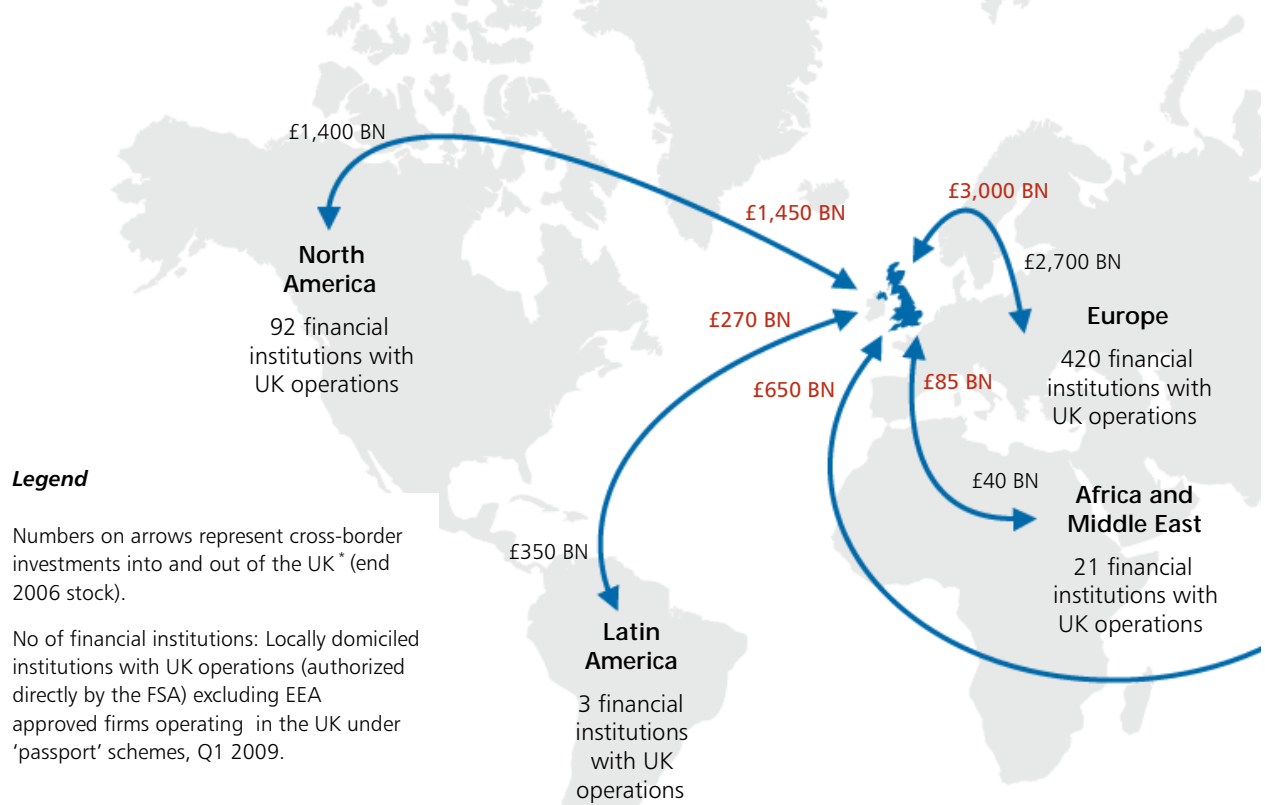
²¹ MasterCard Worldwide: *Worldwide Centers of Commerce Index 2008*.

²² Source: London Stock Exchange.

Figure 5: The importance of the UK to the global financial system²³

The UK is a core market for international financial institutions across the world

More than £10TR in investments into and out of the UK; ~600 foreign financial institutions authorized for business



Legend

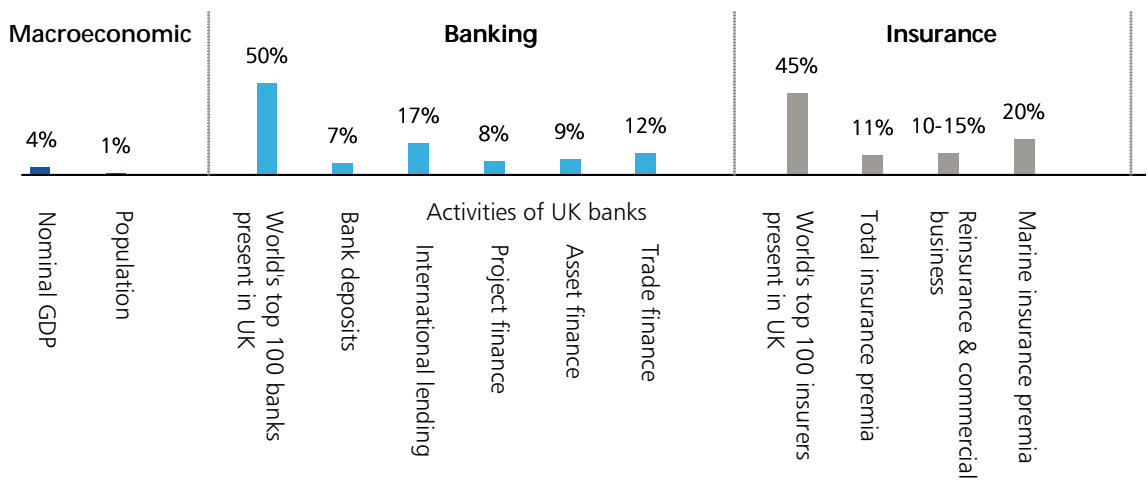
Numbers on arrows represent cross-border investments into and out of the UK * (end 2006 stock).

No of financial institutions: Locally domiciled institutions with UK operations (authorized directly by the FSA) excluding EEA approved firms operating in the UK under 'passport' schemes, Q1 2009.

*Includes direct & portfolio investments, foreign deposits, loans and currency holdings (2006 figures per available national statistics).

A key player in established international financial markets

UK's percentage share of global activity in 2008



²³ Sources: Oliver Wyman research and analysis; Office for National Statistics (ONS); Financial Services Authority (FSA); Bankscope; Dealogic; PricewaterhouseCoopers; IPO Watch; International Financial Services London; World Federation of Exchanges; Bank for International Settlements (BIS); UK Investment Management Association (IMA); British Bankers' Association (BBA); Insurance Information Institute; International Union of Marine Underwriters; Mercer Global Investment Manager (GimD) database; London: *Winning in a Changing World – Review of the Competitiveness of London's Financial Centre*, December 2008.



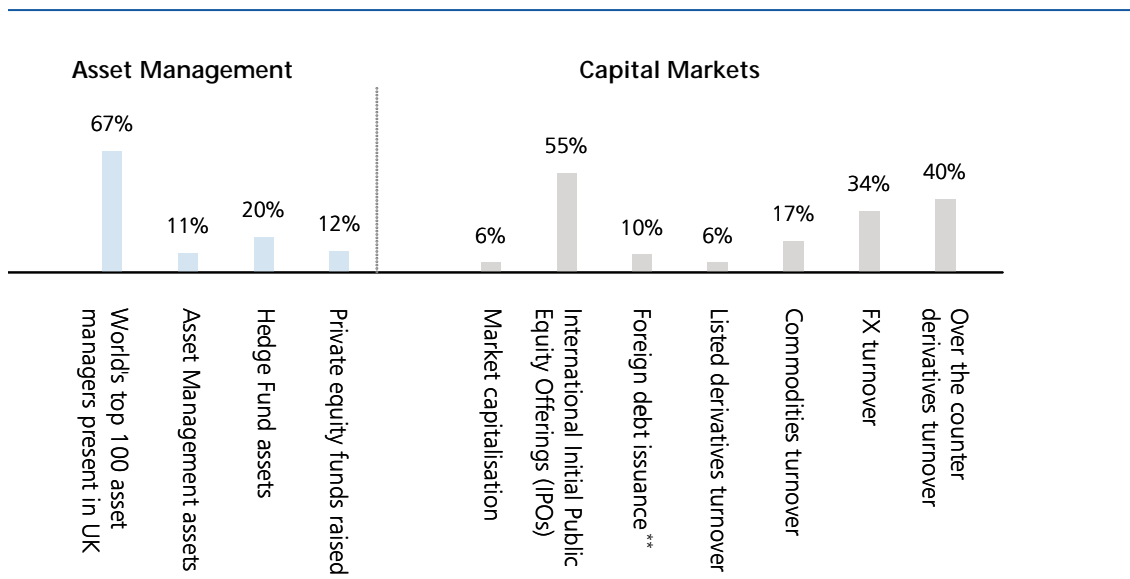
A leader in growth areas

Carbon trading
European Climate Exchange (London) dominates trading in carbon futures market.
59% UK share in purchasing carbon credits under Clean Development Mechanism.

Islamic finance
22 Islamic banks present in the UK
30% share of Sukuk listings (LSE) – 2nd largest market after Dubai Nasdaq.
7 Sharia compliant ETFs in the UK; FTSE launching a Sharia Index with Bursa Malaysia.

Sovereign wealth funds
Sovereign wealth funds holding ~50% of sovereign wealth fund assets present in London
London a key centre for external management of sovereign wealth fund assets.

Financing Emerging Market Growth
UK financial institutions largest financiers of Emerging Markets (16% of outstanding loans)
UK asset managers second largest investors in Emerging Markets (11% of assets).



**Foreign debt issuance defined as cross border issuance in non-domestic currency.

4. The future of international financial services in the UK

The global crisis has hit the UK-based international financial services industry hard. In wholesale banking, some markets remain closed – and some of the more esoteric may never reopen – as the banks focus on rebuilding their core businesses. In international insurance, the volatility of investment markets and the general economic downturn have depressed both investment and premium income, mainly in the life sector. The asset management industry has benefited from increases in savings levels in developed economies – but as in insurance, investment returns are subdued. Even professional services such as accountancy and law have been hit by a decline in financial services-related business, especially in fields such as mergers and acquisitions where activity is greater when the economy is growing.

However, it is not just markets that are undergoing profound change. The large primary international banks, in particular, are focusing on rebuilding their capital and their business models. Income from some capital markets operations has dried up, high levels of impaired assets remain and non-performing loans are increasing as they always do in a recession. These – together with other factors – have affected the ability of banks operating in the UK to maintain recent levels of international liquidity, and resulted in large cuts in highly skilled jobs.

Governments across the world and the banking industry have taken action to ensure the stability of the financial system. These include capital and liquidity injections, government guarantee schemes to support lending and balance sheet restructuring, including write-downs of impaired assets. Where necessary, supervision and risk management systems are being reconfigured to ensure future stability. Global output is forecast to return to growth in 2010.²⁴

The crisis has fundamentally changed the nature of the relationship between governments, regulators,

central banks and the industry. The UK is home to four major international banks – HSBC, Barclays, Standard Chartered and Royal Bank of Scotland. The last has become majority-owned by the state, under the oversight of UK Financial Investments Ltd.²⁵ It aims to act as a shareholder on a commercial basis and to develop a strategy for divesting these shareholdings in an orderly way as soon as possible in line with delivering taxpayer value while taking into account competition and financial stability objectives.

Government shareholdings provide much-needed stability, but also introduce issues such as a potential conflict between national funding agendas and the ability of the global financial system to maintain flows between countries. The pressure on international banks to conserve funds for their domestic markets has arguably, in some cases, led to the withdrawal of bank financing in certain economies. The effectiveness of the new relationships will be tested by the management of, and subsequent exit by governments from, their newly acquired shareholdings.

Whatever the form of financial providers, there will in the future remain fundamental but as yet unmet economic needs that can only be addressed through the development of international financial services – including financial support for ageing populations, market solutions to tackle climate change and investment in infrastructure, particularly in emerging markets. The UK, as a centre for most of the large international financial services firms, should be preparing for this upturn in business.

²⁴ IMF: *World Economic Outlook*, April 2009.

²⁵ <http://www.ukfi.gov.uk>

Volatility and the resilience of international financial centres

There has been much recent discussion of the effects of negative volatility on international financial centres and what it means in terms of critical conditions for success.

There are different causes of negative economic volatility: political, such as World War II; structural such as the UK's recession in the early 1980s; and financial, as in the Great Crash of 1929. There is little that financial centres can do about the first two causes, except attempt to operate as normally as possible. In financial crises, volatility envelopes the whole industry and there is little shelter that any financial centre can seek – unless it has the ability to adapt to change or to develop new business in calmer markets not affected by the downturn. However, global crises do not occur often; more prevalent are market-specific problems.

Volatility can affect different parts of a financial centre's client base:

- by country or region – Asia or Russia in the late 1990s;
- by industry – dotcoms in 2000-01, biotech in the 1990s;
- by financial market – commodities in the early 1970s, equities in 1987, UK foreign exchange in 1992; or
- by the type of business, whether flow or event-driven transactions.

Some have argued that the financial services industry should simplify its business models to end cyclical markets, but this ignores wider economic cycles and fails to analyse the impact of volatility. For example, flow business declines during recessionary periods as overall economic activity drops – but “simple” international debt-related business may actually be more volatile than “higher-value” equity-related flows.²⁶

Different causes of volatility create different impacts on a financial centre's business, and problems of any type will always have an effect over the short term. This is part and parcel of hosting such a business. It is the job of financial service providers to help clients manage volatility. However, our conclusion is that longer-term the real issue is the adaptive capability of a financial centre. This is borne out by the fact that, despite the current difficulties, the UK continues to perform well across the range of international financial business flows.

The ability to adapt is directly linked to some of the existing (sometimes intangible) critical success factors: the facility for self-correction in the regulatory environment; a stable business-focused tax policy; flexible labour laws; a deep pool of skills; and a culture that promotes flexibility and creativity.

The UK has historically demonstrated the capability to change with the times. However if the UK were to lose critical mass in any particular business line, then it would find it difficult to regain it when markets returned. Therefore, to support the cluster effect mentioned above, it is important to maintain a wide range of interlocked markets and not allow niche areas to wither due to a lack of micro-policy support, thereby reducing the overall UK market proposition. Additionally, impacts on the industries client base, will have a knock-on effect on specific financial markets developed to service them. Financial services policy must take a wider view.

²⁶ Review analysis

The way ahead

Our objective in this Report is to agree the keys to success that the UK should act on to maintain and develop its global competitiveness in financial services over the next ten to fifteen years. Such a time-frame leaves any prediction a hostage to fortune, particularly when it is rooted in very short-term considerations. We have taken account of the current financial crisis (especially those issues that are likely to have longer-term repercussions), and of the main trends and factors that were already evident prior to mid-2007 when the problems began to emerge.

It is not the aim of the Report – nor have we tried – to recommend a lengthy list of measures. Instead, it sets out a series of considerations grouped under three broad themes to provide general policy guidance for the longer term, with a number of more specific actions that we propose should be undertaken over the medium term. The three themes are:

1. To establish a clear direction for the UK international financial services industry in partnership with the wider economy and overseas markets.
2. To reaffirm the UK's reputation for competence, responsibility and trustworthiness.
3. To ensure effective delivery of these recommendations.

1. Establish a clear direction for the UK international financial services industry in partnership with the wider economy and overseas markets

The role of the UK-based international financial services industry is often seen primarily through the position of the City of London as a leading global financial centre and the need to preserve its lead as new challengers emerge. Yet while the City is often the point of entry for access to UK international financial services, the real strength of the industry lies in its breadth and depth across the

country. Meanwhile, the “zero-sum game” mindset focusing on the need to fend off what is seen as an international threat to London's position neglects the value created by an efficient financial centre through partnerships in the global financial services supply chain. We believe that the UK needs to challenge the received wisdom on financial hubs; develop existing and establish a new strategy of partnership to strengthen its integration with both the domestic and the international economy.

a. International financial services in the wider UK economy

As noted in the earlier background analysis, the UK financial services industry has two particular strengths:

- The powerful London “cluster effect”,²⁷ where a diverse range of financial and professional services businesses have come together in and around London, boosting productivity, service development and the growth of new business.
- The greater UK financial services clusters that have created major financial centres in Edinburgh and Glasgow, as well as strong secondary centres in cities such as Leeds, Manchester, Liverpool, Bristol and Cardiff.

It is worth acknowledging that the values underpinning London's current reputation are founded on a national, rather than a single-city, embrace of the country's global trading heritage. London's position as the main entry point for international financial services is supported by the industry's relationship with the wider UK economy. Different domestic clusters have tended to specialise within the overall financial services industry – for example, through insurance and pensions operations

²⁷ Michael Porter: Clusters and the New Economics of Competition, Harvard Business Review, November 1998

located in the South West and Wales. There is an increasing geographic diversity of supporting services, as competitive costs and the availability of technical skills open opportunities for firms in newer centres.

Case Study: Belfast – financial sector opportunities from a local skills base

Northern Ireland offers a base within the UK for the provision of international financial services. Competitive operating costs and a highly educated workforce with a sustainable supply of skilled and qualified staff have attracted a growing list of blue-chip financial services firms that includes Fidessa, NYSE Euronext, AllState Citi and Liberty Mutual. Invest Northern Ireland (Invest NI) focuses on the financial services, information, communications and technology sectors and supports its sector-focus through a global network of offices offering a one-stop-shop for investment support.

The UK international financial services sector also plays a vital role in the wider non-financial services economy, in promoting growth and productivity through investment and the provision of business finance. It provides a large share of tax revenues, generates jobs, stimulates technological innovation and creates skills that can be transferred to other sectors.

These factors provide the industry and policy-makers with the incentive to ensure that the benefits from the success of UK-based international financial services continue to spread broadly across the wider economy. Our recommendations, therefore, are:

- The Government and the industry should lead an informed public debate on the role of financial services in the economy, to explain the depth and breadth of the sector and its existing and potential contributions to the wider economy. The aim must be to create a more productive and sustainable relationship between the financial services industry and the wider economy.

- Public bodies across the country should work with the industry to strengthen the involvement in the regional provision of international financial services of the financial and professional sectors.
- The Government and the industry should enhance the links between regional professional services firms and financial centres to generate business, use the wider skills base and reduce costs.

As productivity increases in the financial sector, it is important to ensure that growth is allowed to develop organically. Recent events have led some commentators to conclude that the financial sector should be deliberately constrained or even reduced in size, to ensure economic stability. However, contraction is already happening as a result of the financial crisis,²⁸ and it would be even more damaging to the economy to set a policy target for further reductions solely on the basis of the events of the past few years. Nor is it clear how this could be achieved in practice. This Report recommends that the financial sector be allowed to recalibrate its activities according to the sentiments and demands of the market.

There is, however, a need for the Government, the industry and market participants to ensure that the nature of the sector's growth creates long-term, rather than speculative, economic value. Elsewhere, this report highlights the crucial role of regulation in maintaining checks and balances, and the role of the financial institutions in achieving the outcomes intended by regulation and corporate governance standards.

Finally there is a need for longer-term thinking. As earlier noted, the risks of volatility for an international financial centre – and hence the domestic financial services industry – become greater in times of rapid growth and recession. To help mitigate volatility,

²⁸ HM Treasury: *Pre-Budget Report 2008*. http://www.hm-treasury.gov.uk/d/pbr08_annexa_339.pdf

we suggest that those involved in the international financial services industry are encouraged to embed long-term thinking into their strategic planning, by looking at their businesses over the course of the entire economic cycle.

Regional financial centres should analyse their longer-term opportunities and vulnerabilities within the financial services value-chain in partnership with local universities and financial institutions, and plan appropriately. Many regional financial centres experienced strong employment growth in the past decade; their plans for the next decade need to ensure the sustainability of those jobs.

As noted earlier in the discussion of financial centre volatility, the UK must ensure that it maintains a broad range of financial services. The loss of critical mass in a specific sector can make it more difficult for an international financial centre to regain it when market conditions improve. For example, while poor economic conditions might dampen domestic demand for certain cyclical financial services in the short-term, the Government and the industry should strive to ensure that the UK maintains the relevant base of skills upon which the industry can grow in better times.

b. Working with other countries and financial centres

Perhaps the greatest single factor in the UK's success as a trading nation has been the adherence by successive governments to the philosophy of open and competitive markets – including openness to international ownership of domestic firms. Such a policy has attracted a greater range of external participants, skills and private capital than could reasonably have been generated by the domestic economy alone. This, in turn, has enhanced the ability of the UK-based international financial services industry to adapt constantly to new patterns of economic development and flows of wealth. The

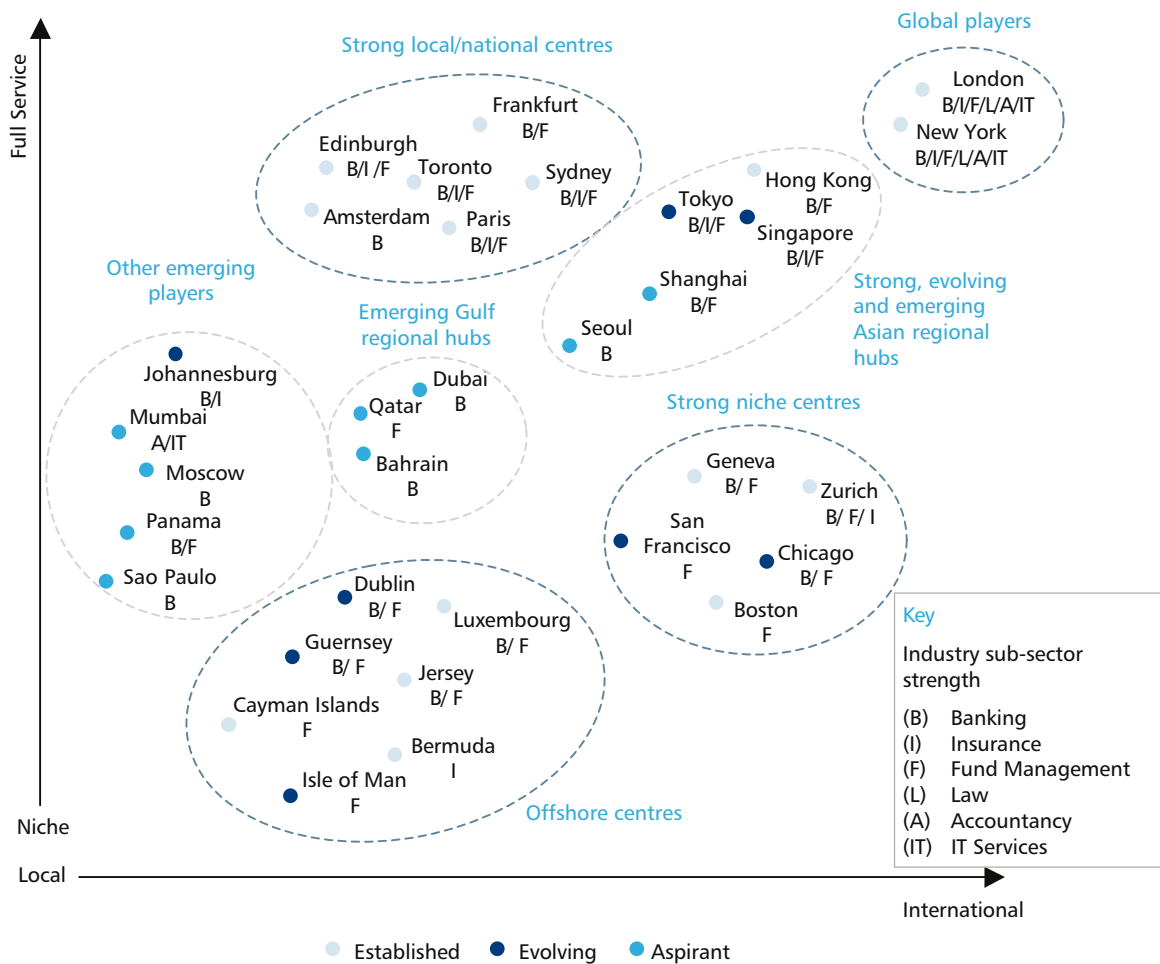
Case study: Edinburgh – a world-renowned centre for asset management

Edinburgh is a leading international financial centre in its own right – and Europe's fifth largest. A world-renowned cluster of financial services firms has formed around the city, with particular strengths in asset management, life assurance and pensions, and banking – including international firms that have chosen Scotland for their European bases, attracted by Edinburgh's long-standing position as a financial centre.

UK's status as an international financial centre depends on the maintenance of an open economy, at a time when protectionist tendencies have been rekindled in many parts of the world as a result of the global crisis.

As noted, the provision of international financial services has historically been an area in which the UK has been both highly involved and recognisably proficient. However, the number of financial centres seeking international business is growing, and Figure 6 shows the emerging landscape. While London and New York are long established international financial centres, new Asian centres such as Singapore and Hong Kong have evolved into well developed regional hubs.

Figure 6: Key financial centres, today and tomorrow ²⁹



²⁹ Source: Citi, Oliver Wyman.

In the light of such developments, we urge policy-makers and the industry to rethink the way that they envisage the posture of the UK’s international financial services industry. Rather than seeing the growth of other financial centres as a threat, it should be seen as an opportunity to develop partnerships that can stimulate international growth and development. In practice this means that discussions about the pre-eminence of the UK’s financial services industry should be more balanced, and more focused on how the industry can support European and global economic growth and foster closer international cooperation.

The UK has a record of success in handling financial flows and in advisory business from Europe, Asia and the Middle East. For many years, individuals, companies and institutions from those regions and others have come to London to seek financial and professional advice, invest funds, raise capital and manage risk. The UK has become an essential part of the global financial services supply chain, working together with other financial centres.

Developing economies require financial services to achieve further progress in building their industries, providing infrastructure and supporting their citizens. The UK has been able to support them through its

leading role in equity and debt issuance, advisory services, value-added insurance and professional services. The more established sovereign wealth funds which have accumulated wealth from the export of commodities or rapid economic growth have often chosen UK-based firms for investment advice, or indeed located investment offices in London.

Case study: Development of China's corporate bond market

In October 2005, the Futures and Options Association (FOA), drawing on research carried out by the International Capital Markets Association (ICMA) Centre at Reading University, produced a study commissioned by UK Trade & Investment on "Developing a Corporate Bond Market and Associated Derivatives Market in China". The development of China's corporate bond market was identified as a policy priority by China's Financial Work Conference, chaired by the Chinese Premier in January 2007. Subsequently, the UK Chancellor and the Chinese Vice-Premier agreed a programme of financial services technical collaboration, at the 2008 UK-China Economic and Financial Dialogue. This covered capital market development and included the corporate bond market.

Seminars were held in Shanghai and Beijing in 2009, with the strong support of the Chinese securities regulator and central bank. Senior representatives from ICMA, UK-based banks, international law firms and financial data agencies participated, complemented by experts from China. The seminars were coordinated by HM Treasury and the British Embassy in Beijing, demonstrating how the UK can harness resources from the public and private sectors for broadening and deepening capital markets in other countries.

In practice, the UK is already part of the greater global financial services value-chain, rather than a pure competitor in a winner-takes-all race – and as an open economy, directly benefits from the wider economic growth that it is helping to foster. It participates in many of the elements in this financial

services value-chain, from low-value but frequent transactions to high-value, episodic ones. All provide support to the underlying economies that require these services, and very few other international financial centres can offer access to and support across so many parts of the chain.

Working with other financial centres has helped the international networks of UK-based international financial services firms to win business for the UK. In return, the UK has provided access to its markets and expertise for overseas companies. It has acted as a template for many developing centres – Hong Kong and Singapore are prime examples in Asia of financial centres that have based themselves on practices in the UK. It has also helped in developing generations of financial professionals who have returned to their home countries after learning their trade in London – whether as market practitioners, regulators or support services providers.

In addition to the work that UK-based financial services firms have carried out to support the development of bond markets in China, other practical examples of formal and informal partnership include the adoption of a UK-based regulatory and legal framework in Singapore and the recruitment of UK-trained regulators for supervisory authorities the Middle East and Asia. UK-based firms have also worked with many other smaller financial centres, helping to build a stronger, more stable and more prosperous global economy. Such partnerships are not simply focused on international capital flows, but also on developing the domestic capital markets in each country. Perhaps the best and arguably most important example is the UK's role in helping to shape the European Union's financial services framework, which serves the needs of the region and the EU's international partnerships.

We strongly recommend that the UK continues to play an active role in the development of the international financial system. Some may fear that

working in partnership with other centres will erode the UK's long-term competitive position in international financial services; but it is clear that many countries are developing their own industries and will increasingly transact more business locally. Acknowledging the large-scale shifts in economic flows, and working with those trends, will help embed the UK in the new markets, and help those markets to be developed in a fashion that will enhance global stability and openness.

An example of the changing nature of the international financial centre landscape is provided in the recent endorsement by China's State Council of a plan to ensure that Shanghai becomes a global financial and shipping centre by 2020,³⁰ while Hong Kong consolidates its current position as a fast-growing regional financial centre. It is entirely possible for China to host two cooperating international centres, given their respective North and South China locations and the forecast growth in the Chinese economy. A comparable situation can be found in the US, which has five major financial centres with international operations - New York, Boston, Chicago, Miami and San Francisco.

Nor does the creation of multiple regional centres mean that these cities will no longer need the services offered by international centres such as London. They will still require specialist advanced services such as the high-value risk management offered by the London insurance and financial markets, as well as access to a wider range of investors for financing local growth and a wider range of investments for the savings of the local population.

The UK should maintain the philosophy of an open economy, which will make it easier to encourage other countries to open their markets to UK-based financial services firms. The industry already works with financial systems around the world. With its

breadth and depth in financial markets, the UK is in an excellent position to form partnerships with emerging economies through its work with local financial centres of all sizes.

Our recommendations are, therefore:

- The UK should actively work through international negotiations to ensure that protectionism does not take hold - it must be avoided to allow recovery and longer-term economic growth to resume;
- The Government and the industry should collaborate to maintain and expand the UK's role as a finance portal for the rest of Europe and the world, supporting other financial centres as they develop their own capabilities and making the UK a source of liquidity and expertise for them;
- The Government and the industry should support financial markets infrastructure initiatives, especially clearing and central counterparties for traded products.
- The Government and the industry must intensify work with emerging market economies, through strengthened economic and financial policy dialogue, the creation of joint ventures, co-investment and training and shadowing schemes to support them in building local capabilities - as well as through sharing experiences on regulation and business models in relation to primary exchange structures and risk management.

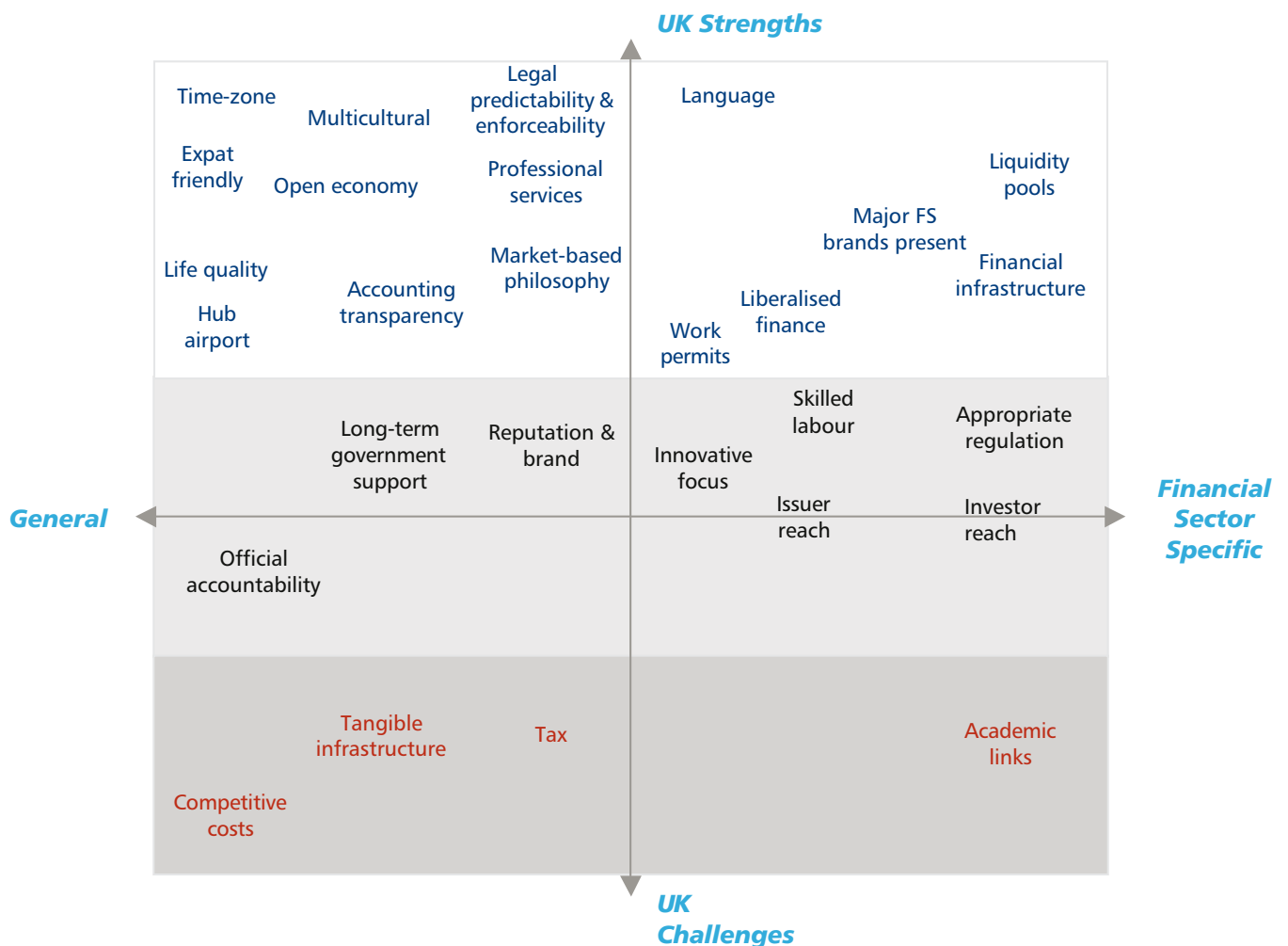
³⁰ *South China Morning Post*, 26 March 2009.

2. Reaffirm the UK's reputation for competence, responsibility and trustworthiness

Good faith and trust are concepts that have long been associated with the UK financial services industry. However, the present financial crisis has challenged public perceptions of the UK's competence, responsibility and trustworthiness in banking and highlighted the need to strengthen its regulatory regime.

Meanwhile, other developments in the global economy have led – as noted in the previous section – to the emergence of new financial centres. The UK industry has enjoyed great success over the years in attracting international financial and related professional services business to the UK. If it is to continue to do so, it must sustain the “critical success factors” needed to be a successful international financial centre.

Figure 7: Critical success factors – where the UK is strong and where more effort is needed³¹



31 Review analysis

Conventional wisdom identifies the key factors for success as competitive regulation, low tax, high skills and good infrastructure – factors that have featured in the strategies adopted by regional financial centres in many developing countries. However, there are many other success factors and Figure 7, shows industry’s views on primary and secondary success factors for the financial services sector and the broader environment³² – where the UK is seen as strong, and where it is perceived to require improvement. We have reviewed whether conventional thinking on these success conditions was justified, and what changes to these factors might be seen in the next ten to fifteen years in the light not just of the current financial crisis and its associated volatility but of a changing global macro-economic picture.

The UK shows a sound overall performance against most of the conditions for success. On the tangible side, it offers a deep skills pool, a widely-respected legal framework, modern financial infrastructure and hub airport links. On the intangible side, it provides an attractive living environment for expatriate families, a fair, flexible and transparent business environment, and an instinctive openness to other cultures and countries (whether people or investment). It also remains Europe’s centre for financial services, and so represents an important trading bloc.

However, the industry criticised specific factors, such as elements of the UK’s built infrastructure and the clarity and continuity of tax policy. Built infrastructure is often cited as a core factor, but our conclusion is that a certain level of infrastructure is required and expected - and after reaching that level it is much less

of a factor than, for example, the legal, accounting and regulatory framework.

The clarity and continuity of tax policy became an issue in 2008 where debate was fuelled largely by concerns over proposed changes to taxation of non-domiciled workers and reforms to capital gains tax. This may have raised issues about the UK’s attractiveness as a centre for international financial services and indeed other industries - beyond which its reputation as an attractive investment destination might have been questioned. These sorts of public debates highlight the importance of identifying trends as early as possible, and deciding whether they are important or more transitory – though unforeseen shocks to the tax system from economic circumstances may in any case require action to secure fiscal sustainability. However, a series of small adverse developments, or a feeling that clients and business partners are being taken for granted, can lead to a tipping point in which the reputation of even a well-established financial centre can be undermined by changing perceptions of core competitiveness.

In the aftermath of the financial crisis, an important priority is the restoration of public trust, addressing the deficiencies that have been revealed by the banking crisis.

In particular, the UK must continue to play an active role in regulatory leadership: future success in international financial services depends on the creation of – and adherence to – high standards. We wish to encourage openness in sharing regulatory insights and in industry and regulatory exchanges with other countries and regions. We also urge the Government to promote collaboration between financial practitioners and work with the industry to ensure critical initiatives are not missed.

We have identified four core success factors that we believe will be important over the longer term

³² A wide range of factors that impinge on financial services competitiveness is used by Z/Yen consultants in compiling the Global Financial Centres Index, published by the City of London Corporation. This analysis sets aside the superficial commentary that the UK’s success is driven mainly by language and time-zone advantages

in maintaining the UK's reputation as a centre for international financial services: regulation, tax, skills and an innovative environment. Our medium-term recommendations on these mainly relate to the banking sector, as this is where the countries that belong to the G20 and regulators in the UK, EU and US are currently focused. Other sectors face similar concerns, such as the need to mitigate pro-cyclicality – but remedies that are appropriate for banking may not be applicable for them.

a. An appropriate regulatory regime

Of all of the critical success factors, we consider that regulation – most specifically of the banking sector – will be of the greatest importance over the next few years. With trust in financial services at a low point, there could be a flight to regulatory rigour and quality. We recommend that the Government should take a leading role in the formulation and implementation of international regulatory standards, in periodically reviewing regulatory structures and in agreeing processes for crisis resolution.

Taking a lead in global regulatory policy-setting

As an international financial centre hosting many large firms whose home supervisor is abroad, the UK has a crucial interest in setting and maintaining high international standards. It should therefore aim to take a leading role in the formulation and implementation of global and EU regulatory standards. To an extent, the UK benefits here from the EU's over-arching regulatory structure – for example, the financial supermarket and consumer protection philosophies. The appropriate authorities in the UK should continue to engage actively and consistently with international regulatory bodies at the global level (such as the Financial Stability Board, the Basel Committee, IASB³³ and IOSCO)³⁴ and at the EU level (with the 'Lamfalussy' committees) to ensure that the UK's experience and best practices are understood as widely as possible.

We urge policy-makers to continue implementing international standards consistently and rigorously in regional and national rules. To ensure that common global standards and rules are not inappropriately applied or distorted by the overuse of national discretion, the UK should promote the rigorous use of peer review, objective verification by international and regional rule-making bodies, colleges of supervisors and mechanisms such as staff exchanges that build trust between regulators. We recognise and welcome that this means submitting the UK's own national practices to greater challenge from other countries. A fragmented international supervisory landscape is a particular challenge in both insurance and banking and we expect UK regulators to play their role in working towards harmonisation.

Policy-makers should continue to recognise the international context of the UK's financial sector when making rules and proposals specifically designed for the UK. The UK should not introduce regulations that are inconsistent with international practices unless there has been a consistent and long-term failure to act at the international or regional level.

We also argue that supervisory and regulatory measures taken in response to the current crisis need to distinguish between, and be proportional to, the experience of different financial services sectors. Regulatory over-reaction in the non-banking sectors could damage the competitiveness of firms that are often engaged in competitive global markets. In the insurance industry in particular, there is less exposure to liquidity risk and large insurers have pointed out that excessive capital requirements are as dangerous and inefficient as inadequate capital requirements.³⁵

In general we believe that fundamental diagnosis is required to distinguish between policy and implementation. Success in both is required, but failure in implementation does not mean the policy

33 International Accounting Standards Board

34 International Organization of Securities Commissions

35 Source: the Geneva Association: principles signed by 50 major insurance CEOs: http://www.genevaassociation.org/PDF/General_Information/GA_Press_Release_2-09.pdf

is wrong; and bad policy cannot be corrected by implementation. The Government and the regulatory community should openly acknowledge the difference, and be prepared to act on both elements as required.

Periodic review of regulatory structures

We recommend that the UK should periodically review regulatory structures and actively seek to lead the EU and global debates on new regulatory architecture. At the EU level we support suggestions to create a new systemic risk body and a regulatory body (or bodies) responsible for setting rules and peer review between EU supervisors. The UK should take a leading role in establishing the regulatory philosophy of this rule-setting and peer-review body (or bodies), the rule-making powers and the scope of the authority.

As part of this, the UK's Tripartite system involving HM Treasury, the Financial Services Authority and the Bank of England should be regularly reviewed and tested to ensure that it operates efficiently and effectively. We strongly support the greater emphasis now being placed on macro-prudential issues. As to the allocation of tasks between the FSA and the Bank of England (and whether different structures would have made meaningful difference to the current crisis), we support a greater degree of "productive overlap" on financial stability and prudential supervision between the two bodies. For this to be effective in future, we would encourage a closer relationship between the FSA and the Bank, and we emphasise the need to continue to build this relationship.

We believe the financial and managerial costs of major change at the current time is not warranted. We strongly believe that a "quadripartite" system – a four-way division of tasks created by splitting of the FSA into a prudential supervisor and a markets supervisor, working with the Bank and HM Treasury – would be inappropriate and unstable.

We also believe that there needs to be more understanding of the interaction between financial regulation and accounting standards. The FSA, the Bank of England and the Financial Reporting Council should work together more closely to ensure a better understanding of the impact of accounting standards on the prudential regime, and vice versa.

The "precautionary principle" should be applied to all rule-making efforts.³⁶ Changes to regulation should deal with what has gone wrong, and future risks that can be identified. The history of responses to past crises suggests that there has often been a "political" response, with unintended consequences. Policy changes should be accompanied by an explicit agreement to undertake an impact assessment, a formal review of progress and a periodic check on whether the policy continues to be appropriate.

Indeed many principles, rules and practices are worth preserving: they should only be replaced in line with the better regulation prescription for effective policy – that is, with proper justification.

Processes for crisis resolution

More work is needed at the global and regional level to agree standards for crisis resolution. The failure of Lehman Brothers showed how little progress has been made on ex-ante agreements on crisis resolution.³⁷ This is a major problem for international firms seeking to locate in the UK, and for the stability of the UK financial system. As an international financial centre, the UK needs to be able to resolve future issues and to put better crisis resolution mechanisms in place.

The UK must take decisive action to strengthen its insolvency regime in order to address some of the difficulties revealed by the failure of Lehman's. International cooperation will also be critical in

³⁶ The precautionary principle states that, in the absence of a consensus on whether a particular policy might have adverse effects, the burden of proof falls on those who advocate the change in policy.

³⁷ *The Joint Administrators' Progress Report (PwC): Lehman Brothers International (Europe) in Administration*, 14 April 2009.

dealing with the insolvency of cross-border firms. We welcome the fact that HM Treasury is shortly to publish a review that will propose a way forward with regard to investment bank insolvency.

The Turner Review³⁸

In October 2008, the Chancellor of the Exchequer asked Lord Turner, Chairman of the Financial Services Authority, to review the causes of the current crisis and make recommendations for reforming UK and international regulation to create a more robust banking system. The Turner Review was published in mid-March and makes clear that the crisis is both complex and global (in the sense that national markets and many of the institutions operating within them are highly interconnected). There was no single cause of the crisis, Lord Turner said - rather a combination of factors that had exposed fundamental weaknesses in the financial system.

The Turner Review set out a wide-ranging series of changes in banking regulation and associated supervisory practices. With some recommendations, the FSA can take action on its own, but international agreement will be needed for others:

- fundamental changes in the regulatory approach to capital, liquidity and accounting;
- system-wide approach to identify and deal with macro-prudential risks, to complement stronger micro-prudential supervision of individual firms;
- changes to the scope of regulation so that the economic substance of activities is regulated, not the legal form; and
- a strengthening of the international framework for the regulation and supervision of cross-border banks, including a new European body that would be both a standard-setter and an overseer in the area of supervision.

Discussion Paper published at the same time listed five outcomes the FSA is seeking to achieve for the global banking regulatory and supervisory framework:

1. Better capitalised banks that are more resilient to liquidity shocks throughout the business cycle;
2. A regulatory framework – in particular capital adequacy rules – that does not amplify the business cycle;
3. Effective supervisory and crisis management arrangements for cross-border groups to reflect the interests of both host and home countries;
4. Identification and control of material risks to financial stability posed by unregulated activities or firms; and
5. Effective action to identify macro-prudential and other risks to financial stability at both national and international levels and effective action to mitigate them.

³⁸ Financial Services Authority: The Turner Review: a regulatory response to the global banking crisis, March 2009.

b. An appropriate taxation regime

Maintaining a stable, sustainable and competitive tax system is important for ensuring that business and financial centres can continue to provide an attractive location for international financial institutions. As the Professional Services Global Competitiveness Group report³⁹ recently noted, the overall design and operation of national tax systems are important factors for companies when deciding where to expand or where to locate their head offices.

There are several dimensions to the issue of an appropriate tax regime. These range from discussions on the headline and effective rates, to the importance of certainty and simplicity, to ensuring a broad tax base. The different aspects of tax competitiveness co-exist alongside other factors affecting the overall business environment in established as well as emerging financial centres – such as regulation, infrastructure and skills. Taxation as a success factor must therefore be considered alongside other factors to see what the UK can offer to international investors and financial institutions as a package.

The recent banking sector recapitalisation actions by governments globally, including in the UK, has meant that the taxpayer has become in some cases a major shareholder in individual financial institutions. We acknowledge that UK taxpayers have underpinned the stability of the banking system in these difficult times and provided it with a platform to support the UK economy over the next decade. The public-sector objective in the medium term will be to protect and create value for the taxpayer, with due regard to the maintenance of financial stability and the need to continue promoting competition in the financial markets.

Given this background, it is imperative for the Government and the industry to work together over the longer-term to manage the inevitable tensions

better between, for example, improving the fiscal position and minimising the tax burden on business and individuals, while also ensuring that the tax system can respond to important market trends and encourage innovation and investment in the financial services sector. In particular, the industry recognises the importance of moving away from a binary discussion on tax rates (“lower at all costs”), and working to ensure that future engagement on taxation issues takes into account the wider set of private-sector and public-sector objectives for the business tax system.

We value the UK retaining a competitive corporate tax regime among developed countries and recognise that, from time to time, tax rates will need to vary as a result of fiscal pressures – for example, in response to the current global recession and to maintain the stability of the financial system. Competitiveness also requires an ability to attract and retain the most able people, as well as successful firms. The future levels of personal and business taxes, balanced against other important factors such as how tax revenue is spent or invested, are of course a matter for government; but we acknowledge that they will always be crucial for reinforcing the UK’s competitiveness over the longer term.

The Business-Government Forum on Tax and Globalisation was set up in April 2008 to discuss ways in which the UK tax system can provide the long-term certainty that multinational companies – including international financial companies – need in the changing context of the international taxation landscape. Recent meetings of the Forum have highlighted that discussions related to the UK’s future tax competitiveness should proceed, for example, in relation to the taxation of intellectual property, a key issue in terms of innovation and investment.

The Forum has agreed to look at the UK’s approach to international aspects of corporate taxation, in order to develop a system that further facilitates UK firms doing business internationally while ensuring that the UK’s tax base is protected. The Forum has also committed to exploring how the Government

³⁹ HM Treasury: *Professional Services Global Competitiveness Report*, March 2009.

and international businesses can work together to improve the relationship in developing and consulting on tax policy. The industry supports that approach and the areas of interaction proposed by the Forum, and hopes that the continuation of this constructive process can help develop some long-term principles that will underpin the industry's goals of achieving a competitive, transparent and modern UK tax system over the next 10 to 15 years.

c. The right skills to support financial services

Having an efficient labour market with the right skills is a critical factor in the success of a financial centre. Over the course of a business cycle, volatility may actually work in favour of a financial centre which has both the capacity and capability to ride out fluctuations in markets, redistributing resources to those market segments that are doing well, while retaining the capacity in core skills and experience to switch back into previously under-performing areas when times improve. Many niche financial centres do not have the same broad reservoir of skills, and may naturally rely on partnership with a larger centre for such skills.

Given the age profile of the industry and the current loss of middle management jobs, many skilled practitioners are set to leave the sector in the coming decade. It is therefore important to maintain the professional standing of the industry as an attractive place to work for the next generation of school-leavers and university graduates. If the industry is to attract some of the brightest and the most capable from the UK and abroad, it must be seen – especially by students – to adhere to the highest standards of professionalism and market integrity, and to be offering opportunities for advancement and reasonable compensation. The industry should also aim to re-engage older and more senior professionals who have temporarily left the workforce, especially those with strong advisory skills.

The Government and the industry should ensure a robust skills base exists for financial services, working together to assess the likely size and skills profile of

the financial services workforce over the medium term. This should focus on:

- skills critical to financial services where shortages are expected - especially legal, analytical, statistical, information technology, risk and management (many of these are related to science, technology, engineering and mathematics – the so-called “STEM” skills);
- management and other skills critical to international financial services - leadership and management, change management, languages; and
- regulatory and compliance knowledge, training and skills.

At an early stage, we additionally suggest that there should be more emphasis in general education policy on supporting financial literacy and future financial skills. Curriculum modules on financial literacy, including the need for financial planning over the course of a lifetime,⁴⁰ should be supported and the industry and the Government should promote the teaching of science and mathematical subjects. The industry and education authorities should form partnerships to provide on-the-job skills training.

We also recommend the deepening of collaboration between the industry and universities to strengthen the future supply of skills for the financial services industry, particularly at undergraduate level. This could involve greater financial or in-kind support from the industry for higher education institutions to help with investment in teaching and facilities, but it should also include closer collaboration on the delivery of courses to promote relevant skills among younger people. Table 1 shows the current supply of graduates to the financial services industry, characterised by their first degree subject.

⁴⁰ See Sandler Review, 2002 on medium and long-term savings in the UK, http://www.hm-treasury.gov.uk/medium_and_long_term_retail_savings_in_uk.htm

Table 1: Percentage of students from each degree discipline entering the financial sector in the UK up to 6 months after graduation in 2006⁴¹

Mathematics	18%
Business studies (including finance and accountancy)	14%
Computer sciences	11%
Engineering and technology	5%
Physical sciences	4%

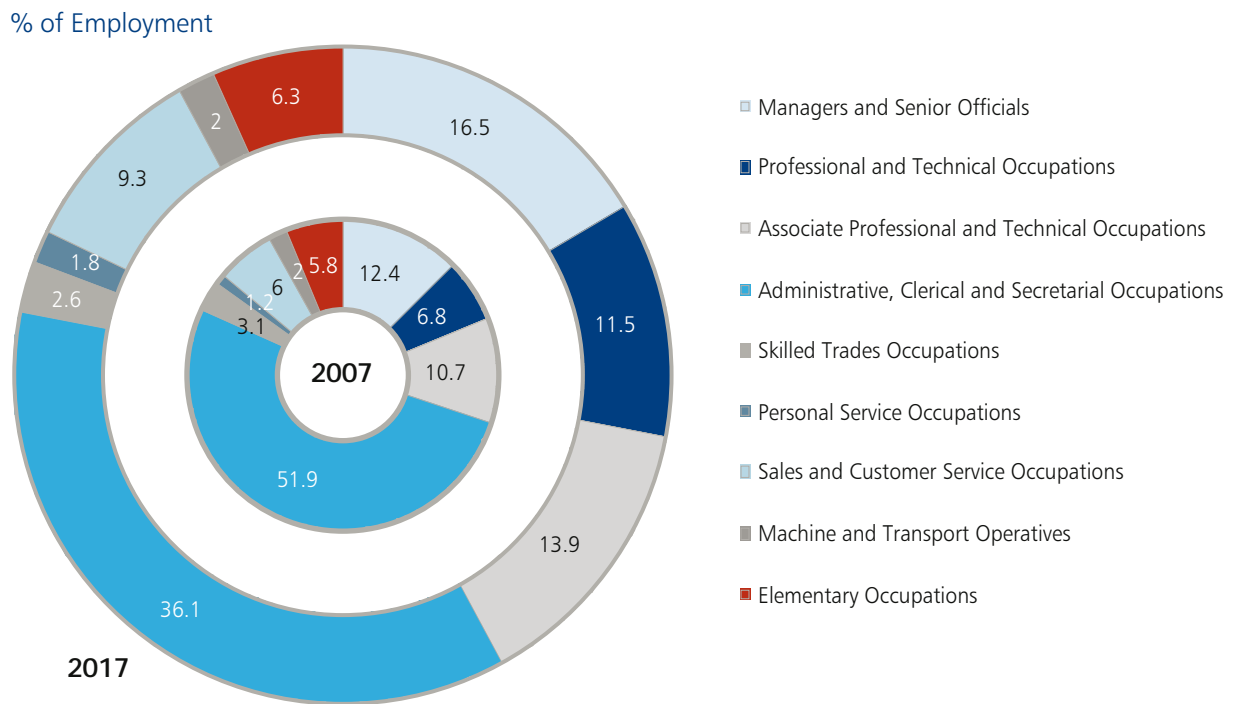
As recommended in the Professional Services Global Competitiveness report,⁴² the Government and the professional services representative bodies should step up the promotion of UK professional services firms, highlighting the value of UK and international professional qualifications.

There is a need to build thought-leadership and skills in the current workforce and among graduates:

- industry, government, regulators and academia should create secondments and exchanges between themselves;
- opportunities for partnership with other financial centres in this work should be developed, including links between UK and international universities.

The financial services industry – particularly in the wholesale markets – must develop and fully embed a more robust approach to continuing professional development which combines both “hard” or quantitative skills (based on technical competence and market knowledge), and “soft” or qualitative

Figure 8: Occupational mix for financial services, 2007 and 2017 forecast⁴³



41 FSGC analysis of Higher Education Statistics Agency data
 42 HM Treasury: *Professional Services Global Competitiveness Report*, March 2009.
 43 Warwick Institute for Employment Research: *Working Futures II*.

skills based on the common principles and values that are conducive to the exercise of sound judgment and responsible conduct of behaviour. Figure 9 shows the future demand for different categories of staff in different financial services, which training programmes will need to support.

The UK's continued ability to attract talent from around the world already makes it a very flexible labour market. Policy-makers should factor into their proposals the needs of the financial services sector for an internationally mobile workforce and whether any new policy will attract such professionals to the UK. This should include the impact of the personal taxation system and the ease of entering the UK to work on a short-term or a long-term basis.

To encourage talented people from overseas to come to the UK, we urge the Government to make a commitment to sustaining the UK's reputation as a world-leading centre where international financial services professionals can pursue their careers. It should ensure that the immigration points system can attract people with scarce financial services skills, including overseas students keen to pursue financial services careers after graduation in the UK. It should also introduce work permit categories to recognise scarce professional services skills, as advocated by the Professional Services Global Competitiveness Group report.⁴⁴

Skills in the professional services sector

Having the right skills in professional services is vital to ensure that the support services essential to the success of the financial services sector continue to underpin the industry. The Professional Services Global Competitiveness Group report⁴⁵ set out a strategy for sustaining the competitiveness of the UK's professional services sector over the next ten to fifteen years. Given the strong connections between that sector and the UK's financial services industry, it is not surprising that many of the strategic considerations set out in the PSGC report are consistent with those found in this Report. In particular:

- the role of professional services firms in promoting sound corporate governance was identified by the PSGC report as "central to laying the foundations for a more stable and sustainable economy in the future". This Report emphasises the importance of rebuilding public trust in the financial services industry, including sound corporate governance and effective oversight. Professional services firms have a significant contribution to make in raising standards of oversight and other forms of risk management; and
- the PSGC report concluded that "high standards of professionalism and human capital in the [professional services] industry should translate into higher skills in client companies." This Report highlights the importance of skill levels in the financial services industry and identifies the positive contribution made by the professional services sector – for example, through the supply of personnel trained in the professional services sector prior to employment in financial services.

⁴⁵ Ibid

⁴⁴ HM Treasury: *Professional Services Global Competitiveness Report*, March 2009

d. Appropriate conditions for financial services innovation

A successful international financial centre needs to be at the leading edge of market developments, and like all forms of economic activity needs innovation to prosper and progress. The Government and the industry should ensure that the financial services industry can remain at the forefront in finding new solutions to emerging financial needs and markets, bringing its expertise to bear in the innovative and efficient deployment of capital in a more capital-constrained environment.

Addressing unmet needs

Society continues to face significant unmet needs which we believe are likely to remain unresolved without significant and continuing development of new financial products and markets. This will occur through changes in financial market participants, the products they use, the platforms they interact on and the processes they follow. The Government, the industry and regulators must continue to encourage and welcome financial research and development where it delivers economic benefit, broader access, increased efficiency and greater safety.

Examples of the major unmet needs faced in the UK include:

- support for economic growth by broadening the available sources of funding for smaller more early stage projects in both the developing and the developed world – now harder than ever following the current sharp contraction of credit;
- national debt management – successfully matching funding needs with investor needs, as the UK's public sector net borrowing figure rises to £175 billion in 2009-10;⁴⁶

- provision for the growing retirement needs of ageing populations – to ensure that society can cope with and afford to support the rising numbers of the elderly and retired in relation to the numbers actively in work (the dependency ratios in mature economies are projected to rise above 25 per cent in the next 15 years);⁴⁷
- finance for an increasingly expensive and complex healthcare system as diagnostics and therapies improve - public and private healthcare costs in the UK could double to £200-225bn over the next 10 years;⁴⁸
- the cost of protection from the impact of climate change and the investment needed for clean energy and environmental improvement – estimates of the investment in global energy production required over the next 20 years top \$1 trillion⁴⁹ per year;
- investment in infrastructure – for example, Africa's unmet infrastructure needs are estimated to total around \$22 billion a year (5 per cent of GDP);⁵⁰
- new forms of investment to connect savers and investors across the world whose faiths do not allow the use of established financial products. Estimates of the value of Islamic finance, for example, range up to \$1 trillion by 2020.⁵¹ London is the largest Islamic finance centre outside the Middle East and Asia.

The UK's leading role in international financial services depends on fostering and supporting new approaches to improve the efficiency and effectiveness of financial products that can meet

⁴⁷ European Commission.

⁴⁸ Department of Health, HM Treasury: *Securing Our Future Health: Taking A Long-Term View*, by Sir Derek Wanless, 2002. EIU.

⁴⁹ IEA estimates (2008 *World Energy Outlook*) that current trends call for energy-supply investment of \$26.3 trillion to 2030, or over \$1 trillion/year. \$9.3 trillion would be required to achieve a targeted 450 ppm of CO2 equivalent.

⁵⁰ World Bank, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/AFRICAEXT/0,,contentMDK:21549323~menuPK:258657~pagePK:2865106~piPK:2865128~theSitePK:258644,00.html>

⁵¹ Dubai International Financial Centre estimates the global market for Islamic financial products to be \$260bn, and forecast to grow at 12-15 per cent annually over the next 10 years

⁴⁶ Chancellor of the Exchequer's budget statement, http://www.hm-treasury.gov.uk/bud_bud09_speech.htm

such needs. A primary focus of the Government and the industry must be to attract innovators and contribute to an environment in which appropriate market development can occur. While innovation by individuals and firms cannot generally be directed by the Government, market development is highly dependent on a number of factors that governments can control – including framework-setting policies to stimulate innovation in certain sectors and immigration policy to make it easier to attract talented people from abroad. The international financial services industry has demonstrated repeatedly that it can provide innovation of social value and thereby enhance development prospects.

Coordination

More immediately, the financial services industry has realised the extent of its own unmet needs in the problems that have emerged over the past 18 months. Dealing with these problems will require coordinated action across products, processes and platforms, and the aim should be to make the UK a leader in developing and commercialising solutions.

Examples include:

- finding global solutions to reduce the systemic risks that led to the current financial crisis – such as arbitrage between lending, trading and special investment vehicles, liquidity risk, over-reliance on credit rating agencies, accounting standards and short-term bank incentive structures;
- improving market safety by installing central counterparty or clearing-house “circuit breakers” to intermediate counterparty and operational risks in a wider range of markets – reducing the number of firms that are too big or too interconnected to fail;
- taking initiatives on global systemic risk oversight – where the UK’s global role should help develop an approach to address country risk concentrations;

- strengthening corporate governance focus on risk-related organisational structures and processes – including the financial activities of non-financial firms; and
- supporting interconnected, fast and safe communications by investing significantly in communications infrastructure and hardware.

To ensure that the UK-based financial services industry remains at the forefront of innovation, we recommend that the Government uses regulatory and other initiatives to promote the UK as a location for financial innovation. Industry associations and business links to academia should be used to complement the strategic efforts of individual firms in tackling emerging financial needs.

The Government should promote collaboration between stakeholders in finding solutions to eliminate the systemic risks that led to the current crisis – for example, in creating clearing and central counterparties for over-the-counter and traded securities markets. The industry should invest in financial infrastructure to support international financial services, in particular in clearing and central counterparties for traded markets.

Finally, a clear strategy is required to ensure that technology infrastructure - including power, communications and IT server and network capacity - can support growth in financial services.

Regulation of financial innovation

We suggest that the less desirable results of certain categories of innovation should be tackled by

Table 2: Examples of positive innovation⁵²

Market dimension	Examples of positive innovation
Participants	<ul style="list-style-type: none"> • Insurers and re-insurers – offering specialist protection in new markets. • Pension reforms – allowing investments in broader asset classes. • Alternative investors – funding higher-risk investments. • Retail note providers – offering tailored saving products.
Products	<ul style="list-style-type: none"> • Internet banking. • Insurance market reforms. • Index funds, discount brokerage, exchange traded funds - providing cheaper access to investment markets. • Venture capital – funding the growth of earlier-stage and higher-risk companies. • Emerging markets corporate finance, microfinance – supporting widespread economic development. • Improving mortgage availability (fixed/floating rate flexibility, offsets etc) – providing broader, cheaper and more flexible access to home financing. • Infrastructure investing, PFI⁵³ – allowing more rapid and cheaper funding of infrastructure projects. • Derivatives – allowing true economic transfer of risks to those more able to hold them. • Islamic finance - unlocking broader investor access.
Platforms	<ul style="list-style-type: none"> • E-trading systems, customer-to-customer trading platforms – decreasing costs and increasing speed and functionality for trading. • Central clearing, central counterparties – decreasing risks and improving market efficiency. • Growth equity markets (such as UK AIM) – providing broader access to equity funding for smaller fast growing companies.

regulators and market participants, addressing each innovation on its merits. Regulatory policy should allow responsible financial innovation and governance that will ensure its suitability before penetration of a new product becomes widespread.

We recommend that regulators and the industry should ensure robust risk management in the introduction of new products and processes:

- conduct of business regulation - examining the impact on consumers and investors;

- prudential supervision - the appropriate accounting for and risk recognition of transactions; and
- financial stability - the potential systemic implications of new products.

Where intervention is desired because of risks or client concerns, we would encourage government and regulators to seek European and global co-ordination.

⁵² Review analysis

⁵³ Private Finance Initiative

We urge the UK to ensure that remuneration structures, policies and governance are adapted to eliminate inappropriate incentives by aligning with the guidelines already published by the Financial Services Authority, the Financial Stability Board and the Institute of International Finance. UK financial institutions, supported by the work of the Walker Review,⁵⁴ must strengthen their corporate governance focus on risk-related organisational structures and processes.

3. Ensure effective delivery of these recommendations

The Report's previous sections have set out the Group's proposed considerations which, put together, constitute a framework for strengthening and improving the competitiveness of the UK financial services sector over the next ten to fifteen years as the global economy emerges from the current crisis. Translating this framework into beneficial outcomes is just as important as getting the framework itself right.

This section looks at how to ensure more productive and targeted dialogue between the Government, the industry and other market participants on issues relating to the long-term strategic development of the UK-based international financial services industry, and in particular how these parties could work together to explain more effectively the strengths and offerings of London and the UK to the wider economy and to markets around the world.

The Group believes that the range of considerations identified in this report so far fall into one or more of the following functions:

1. General strategy formulation (short-term and long-term).
2. Policy implementation.
3. Single-issue based input.
4. Ideas generation.

5. Supporting high industry standards and best practices.
6. Explaining what the industry can deliver in the UK and globally.

The Group's view is that to be successful, a financial sector should have in place mechanisms to enable effective discussion and consultation on all these issues in dialogue between the Government, the industry and other market participants.

For general strategy formulation, current dialogue between the Government and the industry primarily takes place through and under the auspices of the Chancellor's High-Level Group (HLG), which was set up in 2006 to develop and support the promotion of London as an international financial centre.

Several projects have resulted from HLG deliberations, including valuable work led by UK Trade & Investment (UKTI) to implement a financial services promotional strategy, initiatives on Islamic finance and carbon markets, and a public-private partnership on thought-leadership in financial regulation. This Report was commissioned under the auspices of the HLG last year, alongside more specific groups set up to examine and prioritise the challenges facing financial services sub-sectors such as insurance, asset management and professional services.

The Group believes that elements of the HLG's existing sectoral coverage and policy focus can provide the foundation for a longer-term mechanism for engagement between the Government, the industry and other market participants. We propose that the Government should work to re-orient the HLG's objectives, structure and membership to develop into a leaner forum led by the Government that can focus on all strategic issues relating to the Government's relationship with the UK financial services industry, of which the international industry is a major part.

To be sustainable over the long term, this core or strategy group should be limited in size and have formal and informal links to bodies that play a

⁵⁴ Independent review of corporate governance of the UK banking industry, announced 9 February 2009

role in delivering functions 2-6 above. This would help ensure that ad hoc engagement between the Government, the industry and other market participants on issues affecting policy delivery can be dealt with in other forums, while ensuring that the core group can maintain the long-term perspective and act as a sounding board on domestic and international developments affecting the UK financial services sector, taking into account ongoing initiatives and policy changes in the US, EU and other major markets.

We suggest that the core group might develop a work plan using the considerations of this Report, along with the findings of the insurance, asset management and professional services groups and other recent reports related to the position of London and the UK as a leading international financial centre.

A structure for promotion

One important aspect of implementing the Report's policy framework will be for the UK-based international financial services industry, together with the Government, to explain and demonstrate its strengths to overseas markets. This needs to be done in an inclusive way that embodies an awareness of how such efforts are perceived by UK-wide market participants and international clients from diverse cultural and economic backgrounds.

There are currently a number of bodies that exist to promote the Square Mile as a business district, London as a financial centre, the regions and their financial cluster capabilities, and sub-sectors of the overall financial services industry. The number of organisations involved in explaining what the UK has to offer is born out of historical precedent, and in some ways helps to ensure that all aspects of the UK's strengths are promoted.

Equally, however, the multiplicity of bodies has sometimes challenged overseas investors seeking one clear route into the UK-based international financial services community. This situation, highlighted in a

recent report on the competitiveness of London's financial centre,⁵⁵ also forces industry participants to dedicate costly resources and personnel to different bodies. Furthermore, it raises the question of whether different organisations coordinate their efforts to avoid duplication and ensure coherence in their objectives.

We believe that a fresh approach is now needed, with steps to strengthen further the quality of the promotional work for the UK-based international financial services industry, as well as the structures that deliver it.

To ensure this outcome, all UK-based organisations involved in promotional work, as well as their representatives in overseas markets, should operate within the following parameters:

- clear objectives;
- representative membership;
- High governance and professional standards – including the deployment of well-qualified individuals with recent, senior commercial experience; and
- strong awareness of the views and needs of the UK's wider corporate community and users of international financial services.

In addition, the Government, the industry and organisations involved in promotional work should consider a process of rationalisation and consolidation to reduce duplication. They should aim to ensure that promotional resources from the private and public sectors are eventually focused on a single body. That process can only be successful if the participants of the UK-based firms that contribute in-kind resources or subscription fees play a stronger and critical function in the work of these organisations, to challenge poor performance while continuing to encourage value-adding work.

⁵⁵ London: *Winning in a Changing World – Review of the Competitiveness of London's Financial Centre*, December 2008

To achieve these objectives, the Government and the industry should support the existing work – under way in consultation with UKTI and other interested parties – to establish an independent body that is permanent, practitioner-led, politically neutral, strategic and cross-sectoral.

The body should aim to follow the best practice parameters set out above, and should have a formal link to the strategy group which we propose could evolve out of the HLG. The body should work to demonstrate the importance of the UK financial services industry to a broader British audience as well as to explain and market the strengths of the industry overseas.

Conclusion

This Report has argued that while the financial services sector is only one of the drivers of the UK economy, it does – contrary to current perceptions – perform a vital role. We must find ways to supply the capital needs of the UK and the rest of the world to face the growing challenges of the 21st century. The world is facing many fundamental challenges: climate change, poverty reduction and the provision of healthcare, social protection and pensions, to more people than ever before. This effort will require an enormous contribution from the international financial services industry if it is to succeed.

The present crisis makes it particularly challenging to forecast the shape of the world economy over the next ten to fifteen years, except to suggest that it may not resemble the world economy of the last two decades. The UK's interests will best be served by marshalling its considerable experience in both the public and private sectors to promote the highest degree of cooperation possible in an increasingly multi-polar world.

In this Report, the Government and the industry are agreed that the financial services sector is both a necessary and valuable resource. Indeed it constitutes one of the UK's key comparative advantages in terms of jobs, skills and foreign trade. It does not need special treatment. But it does need the Government and the industry to take the long view and work in partnership - consistently, predictably and transparently. If public policy and its execution can provide a stable environment, the financial services industry should provide great benefits to the UK economy.

This Report has suggested a number of long-term ways in which this can be achieved. We have been guided by the objective of better integrating the international financial services industry into the UK economy; and of developing a strategic partnership

with other financial centres around the world. The Report has also argued that the UK's regulators should demonstrate their willingness to take a lead on what is appropriate for the industry.

Additionally we suggest that the UK should develop a framework to connect industry and government in a partnership that ensures public policy changes affecting financial services always start with an acknowledgment of the high value the UK places on the sector, and that the Government should seek the full involvement and technical expertise of the industry in drafting proposals.

While the financial services industry and the economy have endured a difficult period, we suggest that now is the right time for the Government and the industry to work in partnership to ensure the future success – not just of the industry itself, but of the wider UK economy and the international financial system.

Appendices

1. Terms of reference

The increasing integration of global financial markets highlights the growing importance of competitiveness and innovation among financial centres and their participants. The Financial Services Global Competitiveness (FSGC) Group will consider the medium- to longer-term trends impacting the competitiveness of the global financial services industry, against the changing international economic landscape and the emergence of new financial centres. The Group will produce a practical analysis on the basis of its examination of these issues, and a range of considerations that ought to be addressed. The analysis should enable the High-Level Group to prioritise the commercial challenges for the UK-based financial services industry and related public policy challenges (including horizontal issues as well as those specific to the industry).

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