London under siege

Executive summary

- A recent survey by the CBI and PricewaterhouseCoopers makes for grim reading. It found that levels of business activity in the financial services sector have fallen for the fourth successive quarter, with the most recent drop being the steepest since the CBI began monitoring the sector in 1989.

After the financial tsunami of recent weeks, what are the prospects for London's future as a major financial centre? In the short term, they appear pretty bleak. The UK's financial sector is set to contract (or "de-leverage") dramatically, and its earnings and contribution to the economy will also shrink. Indeed, it has become clear that much of the profit the City generated over the past few years has not been genuine.

A pointer to what lies ahead was provided by the CBI's most recent survey, compiled with PricewaterhouseCoopers, of the financial services sector, covering the third quarter. Released at the end of September, it makes for grim reading. The survey found that levels of business activity have fallen for the fourth successive quarter and the most recent drop was the steepest recorded since the CBI first began regularly monitoring the sector's health back at the end of 1989.

In the three months to the end of September, the major banks, building societies, insurers, fund managers and securities houses shed 8,000 jobs. The CBI predicted that at least 12,000 more positions would be lost by the end of this year. Not surprisingly, 44% of the companies responding to the survey expected to be making redundancies over the next three months compared with 19% in the previous survey at the end of June.

As the CBI's deputy director-general, John Cridland, observed: "Firms have become more fearful about the extent and length of the credit crunch and they are now looking to cut more jobs and scale back investment."

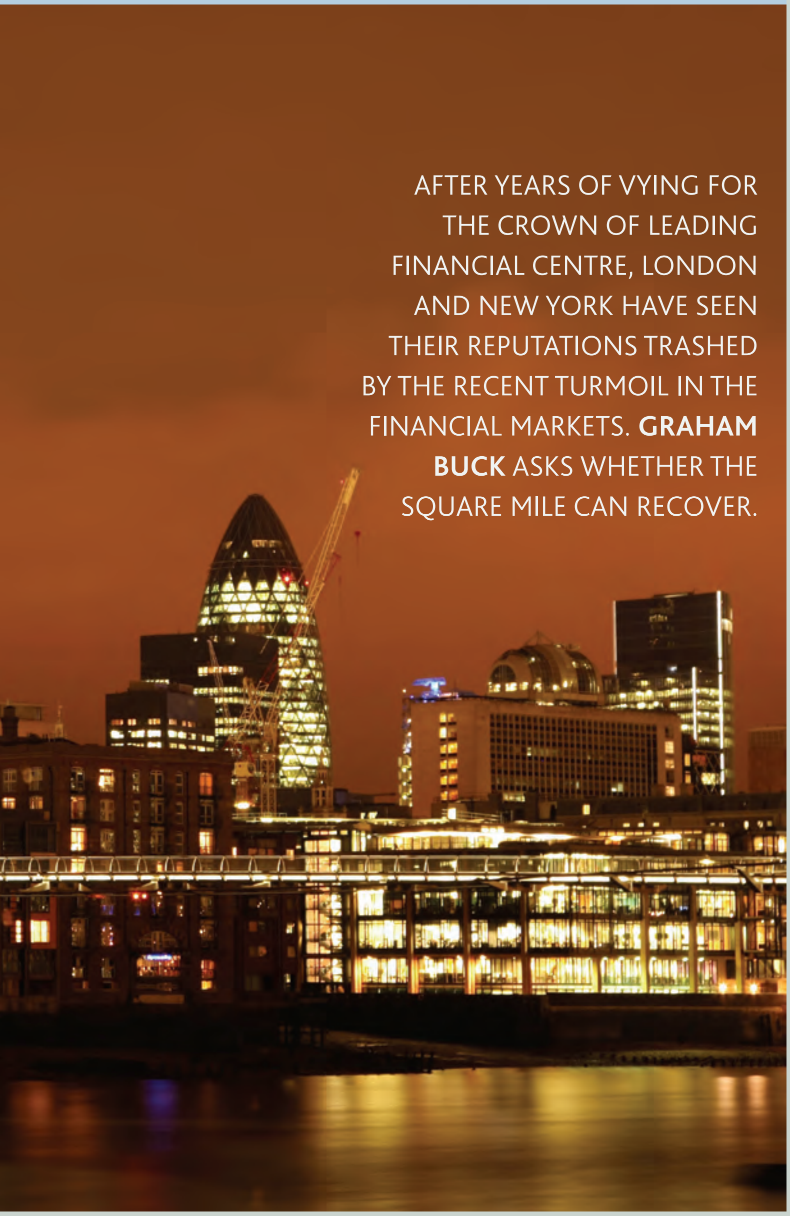
THE RISE AND FALL OF LONDON After a prolonged period of feasting, it was inevitable that the capital would eventually face leaner times. London's growth as a financial centre in recent years, to the point where it has threatened to displace New York, owes much to two factors. The first was the light-touch regulatory regime, which has given markets such as AIM a clear advantage over US rivals such as Nasdaq; the second was the relatively low rate of corporation tax in the UK.

The increasing rivalry between the two cities in recent years, and London's growing ability to attract financial business, alarmed the Big Apple's political leaders and its mayor, Michael Bloomberg. Many banks have either set up or expanded their base in London as it offers a convenient location for developing their business in the fast-growing economies of Asia. At the same time, the onerous reporting requirements of the Sarbanes-Oxley Act in the US encouraged many foreign companies seeking a listing to choose London's stock markets over New York's, and even persuaded companies already on the US exchanges to de-list.

Three years ago, city rankings based on proceeds from initial public offerings saw the UK capital overtake New York and spurred US officials to call for regulatory changes to enhance Wall Street's attraction to foreign companies.

But London's advantages have been looking ever more precarious in more recent times. Light-touch regulation is looking increasingly inappropriate, and is blamed for much of the havoc in the financial markets as the repercussions of the credit crunch have intensified and claimed big name victims.

The Northern Rock episode showed the weakness of the current regime, with no clear division of responsibility between the Financial Services Authority, the Bank of England and the government, leading



AFTER YEARS OF VYING FOR THE CROWN OF LEADING FINANCIAL CENTRE, LONDON AND NEW YORK HAVE SEEN THEIR REPUTATIONS TRASHED BY THE RECENT TURMOIL IN THE FINANCIAL MARKETS. **GRAHAM BUCK** ASKS WHETHER THE SQUARE MILE CAN RECOVER.

LONDON'S ADVANTAGES HAVE BEEN LOOKING EVER MORE PRECARIOUS IN MORE RECENT TIMES. LIGHT-TOUCH REGULATION IS LOOKING INCREASINGLY INAPPROPRIATE, AND IS BLAMED FOR MUCH OF THE HAVOC IN THE FINANCIAL MARKETS AS THE REPERCUSSIONS OF THE CREDIT CRUNCH HAVE INTENSIFIED AND CLAIMED BIG NAME VICTIMS.

to a lengthy period of uncertainty before the eventual decision to nationalise. The prime minister, who in his 10 years as chancellor indicated that the government was happy with a hands-off regime, is now promoting himself as the politician best equipped to tackle "irresponsible behaviour". As analysts have noted, Labour's love affair with the City is coming to an end and the pendulum is set to swing the other way, with tighter financial regulation and a crackdown on alternative tax regimes and tax haven abuse.

RELOCATION IS ON THE INCREASE The UK's corporation tax rate has also lost much of its allure. While at 28% it still compares favourably with those of the other G7 nations, Ireland's rate of only 12.5% is attracting several FTSE 100 companies and other locations are also more seductive. Shire Pharmaceuticals and United Business Media voted with their feet earlier this year, announcing plans to relocate their head offices to Dublin. More recently, advertising agency WPP, investment group Henderson and engineering group Charter announced a similar move, while Krom River Partners said it would relocate to Zurich.

"Financial services is the number one success story in London, but it is looking more and more likely that this will change," says Jérôme de Lavenère Lussan, managing partner of investment management consultancy Laven Partners. "We are not expecting a mass exodus of managers, but a steady erosion of the financial industry, which is very mobile, as asset managers decide to move out for personal, lifestyle and tax reasons."

These to some extent reflect the capital's success since the 1980s, when most "financial foreigners" started arriving, he adds. London has become a very modern city, but at the same time a busy one that suffers from pollution, poor infrastructure and perceived rising crime levels.

On top of that the government runs the risk of making the industry feel unwelcome through tax investigations and ambiguous tax rules.

"People who may have been toying with the idea of moving are starting to act," says de Lavenère Lussan. "Our neighbours are waiting. The Swiss have established a special committee to review how they can be more competitive, and are considering tax breaks for performance fees or carried interests."

Martin O'Donovan, assistant director for policy and technical at the ACT, points out that tax disincentives are not the whole story. There is a further point, relatively minor but nonetheless relevant, that the ACT is about to take up with the HMRC, he says: "Namely, that borrowers have to go through a long and tedious process to be allowed to pay interest gross to foreign lenders in countries where treaties allow it.

"The net result is that the UK is not really an easy place to raise international bank borrowings and lenders might prefer not to lend into the UK. At a time when banks are reining in their lending, this is just another difficulty for British plcs."

IMPACT ON THE CAPITAL London's new mayor, Boris Johnson, appears to be keenly aware of the threat to the City's international standing. In June, shortly after taking office, he announced an initiative between the City of London Corporation and senior executives, headed by Bob Wigley, chairman of Merrill Lynch Europe, to explore how London could sustain its position as a leading financial centre. The team would include senior leaders from the banking, insurance, hedge fund, venture capital, legal and accountancy sectors and its members include John Varley and Andrew Moss, the chief executives of Barclays and Aviva respectively, Lloyd's of London chairman Lord Peter Levene, 3i Group's chief executive Philip Yea and KPMG's UK chairman John Griffith Jones.

In the meantime, as banks de-leverage, credit becomes more expensive and capital remains in short supply, the impact on London's commercial property market is already evident. The value of offices in the City district has fallen by 27% since its peak in July 2007, with the drop occurring even before the sudden and dramatic reversal of fortune for the major investment banks in mid-September.

WHETHER LONDON BENEFITS FROM ITS RIVAL'S DISCOMFITURE OR SUFFERS SEVERE COLLATERAL DAMAGE REMAINS TO BE SEEN.

Lehman Brothers was unable to find a rescue and allowed to go under, although large chunks of its empire are being acquired by Barclays and Nomura. Nonetheless, there is suddenly a lot of vacant office space in the heart of Canary Wharf in London, where Lehman occupies more than one million square feet at 25 Bank Street.

Merrill Lynch has been swallowed whole by Bank of America, insurer AIG is selling off units in return for its $85bn rescue (with a further $38bn since added), and even Goldman Sachs and Morgan Stanley have voluntarily agreed to convert and become regulated commercial banks. The latter move could potentially curtail their activities, although as both have reduced their reliance on short-term borrowing, sold off assets and raised capital in recent months, it could prove enough to ensure their wings are not clipped too much. But in a more regulated, more risk-averse era, the surviving investment banks might scale back their ambitions and opt to become more niche players than before.

Also vulnerable are the ranks of private equity groups. These could thin dramatically as banks refuse to support deals that are not underpinned by much greater amounts of equity and correspondingly lower levels of debt. Jon Moulton, head of Alchemy Partners, has predicted that many deals entered into by other private equity firms in the boom era will come unstuck and that anywhere between 50 and 200 of them are in danger of breaching their banking covenants unless they can refinance on better terms. Otherwise, their options will be either debt-for-equity swaps or bankruptcy. Merger and acquisition activity is already down sharply as planned deals – such as the bid for publisher Informa by a private equity consortium – are abandoned or put on hold.

Hedge funds, which also thrived during the boom, are also likely to reduce in number as they can no longer achieve the stellar returns that previously attracted investors. Apart from Peloton Partners, which was forced to liquidate two investment funds in March, the credit crunch has yet to claim any major hedge funds but reports suggest that many more have suffered sharply reduced returns and risk losing disillusioned investors.

STRATEGIC ADVANTAGES In the longer term, London may gain some consolation from the likelihood that its status as a world-class financial centre will suffer less damage than New York's. Three of New York's five main investment banks have either collapsed or succumbed to an 11th hour rescue, and the world's biggest insurance group has effectively been nationalised.

Germany's finance minister, Peer Steinbrück, expects the recent turmoil to end the role of the US as a global financial superpower and predicts that the world will become multipolar, with Europe and Asia providing stronger and better capitalised centres. But Wall Street has traditionally shown itself able to recover from calamity and reinvent itself, even if this time around the comeback takes longer.

Meanwhile, whether London benefits from its rival's discomfiture or suffers severe collateral damage remains to be seen: the beneficiaries could just as easily be Hong Kong, Tokyo or Dubai. Both London and New York benefit from three strategic advantages, as The Financial Times recently pointed out. First is the primacy of English as the language of business and the absence of any challenger. Second is the established UK and US legal systems, which, despite excessive litigation and high fees, still provide a staunch defence of corporate rights. Third is the collective brainpower in each city. As The FT went on to say, paradoxically it was these self-styled masters of the universe who created the crisis that has felled their financial sector but will, in turn, be instrumental in devising solutions that lead to its renewal.

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