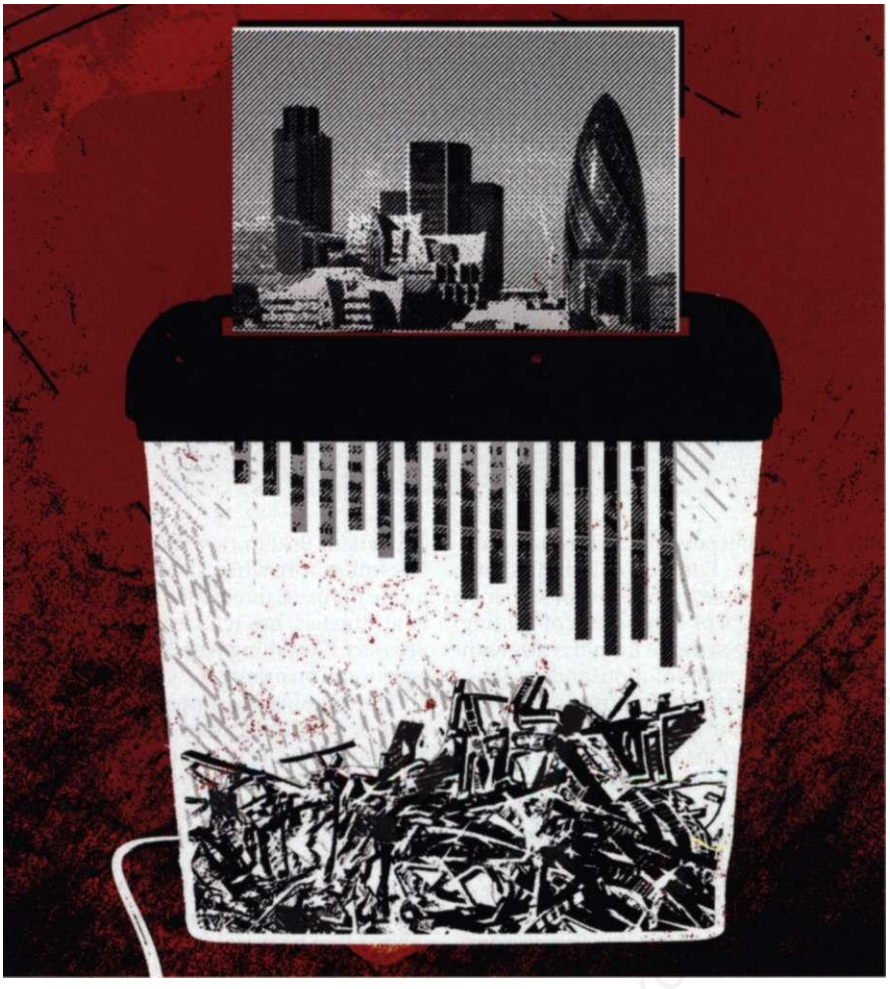


Death by a thousand cuts

The City is one of Britain's great export industries. Yet its continued success is far from certain

FROM high up in their towers some 90,000 bankers look down on the Thames as it meanders past what was, in living memory, the world's busiest port. Six decades ago these shores saw a daily tide of vessels from the world's biggest merchant fleet, built in the world's most productive shipyards and supported by the world's major shipping insurers, bankers and lawyers. Today, little of this great port remains beyond the colourful names of the docks and piers where steamers and clippers once moored: Canary Wharf, Canada Square, or the West India Quay.

That Britain's most successful industry-its biggest exporter, taxpayer and provider of well-paid jobs-has risen from the ashes of another is an accident of history. Yet it is also a reminder that market dominance can be ephemeral. And it explains much of the anxiety in the City, as London's financial district is called, that financial services are under attack.

The City faces a deep downturn in many of its main markets as credit becomes scarcer and as Europe's crisis drags on, slowing investment and trade. It also faces an onslaught of regulation, some of it home-grown, such as Britain's proposals to make banks split their retail banking arms from their freewheeling investment-banking business; and it is threatened by higher taxes on the rich and tougher rules on immigration. Even more regulation comes from abroad, whether it is the new rules agreed in Basel that will force all banks everywhere to reduce the leverage that inflated their profits before the financial crisis, or the rules being drafted by the European Union that seem suspiciously designed to hobble the City and to shift some of its activities to rival financial centres in Paris and Frankfurt. The City also faces a fundamental set of challenges: are its skills and history, its networks of firms and the liquidity of its markets enough to keep it the world's pre-eminent international financial centre, even as the weight of global economic activity shifts to Asia?

Dividing the house

Regulators are naturally obsessed with the financial crisis of 2008-09. In Britain, following the Vickers Commission report, they want to construct a "ring-fence" around the domestic, retail arms of British banks that will separate them from the banks' international, wholesale and capital-markets businesses. These ring-fenced banks will contain the bits of banking that are essential to the health of the rest of the British economy, such as payment systems and loans to people and small businesses. They will have to hold much more capital than they do now, and will be barred from many sorts of risky or international business. In short, they are meant to be boring and heavily regulated utilities with little scope for racy profits but also much less chance of blowing up.

The bits of banking outside this ring-fence will be allowed to take all sorts of risk, but will also have to prepare detailed "living wills" that will help bank supervisors wind them up if they fail. The proposals are intended to ensure that British taxpayers never again have to bail out a banking sector that dwarfs the national economy (see chart 1). At the height of the financial crisis Britain feared not only the collapse of banks that were too big to fail, but the terrifying risk of having to bail out banks that might have been too big to save.

The proposed ring-fence has been furiously opposed by many of Britain's biggest banks, which are seeing their own borrowing costs rise steeply alongside the steady withdrawal of the implicit government guarantee that had underpinned much of their borrowing. The cost to banks of implementing Vickers is likely to be significant: perhaps £3.5 billion to £8 billion ($5.4 billion to $12.5 billion) a year, or even higher. Costs this big will probably force banks to trim their wholesale banking businesses. Royal Bank of Scotland, now majority-state-owned after being bailed out during the crisis, has largely abandoned its ambitions to be big in global investment banking. Barclays, which has a big British retail bank alongside an international investment bank, may also find itself forced to cut back some of its trading businesses. British bankers protest that rules restricting the global scope of British-owned banks would dent London's ability to attract investment and maintain its share of the trade in equities, bonds and currencies. "How can we expect anyone to come here if we aren't here?" grumbles one.

Such complaints, however, may soon wear thin. Clipping the wings of British-

• owned banks would force them to contract. It need not, however, cripple the City as a financial centre. Most of its growth over the past six decades has come from international banks choosing to do business in London rather than from the growth of British-owned banks. TheCityuk, a lobby group, reckons that 251 foreign banks have branches or subsidiaries in London and that over half of all British banking assets are owned by foreign banks. This "Wimbledon effect", in which Britain provides the courts but not necessarily the players, is especially pronounced in trading and other wholesale-banking businesses.

Some 40% of currency trading and 46% in O T C derivatives (those not traded on exchanges) takes place in Britain (see table). Yet Barclays is the only British bank among the world's five biggest investment banks (by revenue from trading bonds, currencies and commodities). Another of the top five is Deutsche Bank, a German bank with its headquarters in Frankfurt that conducts most of its trading in London, where it employs more than 8,000 people.

London's lead

Financial markets share by country, %

● Market leader

	Britain	US	Japan	France	Germany	Hong Kong	Singapore	Others
Cross-border bank lending *(March 2011)*	● 18	12	9	8	9	3	3	38
Foreign-exchange turnover *(April 2011)*	● 40	15	5	3	2	5	7	24
Exchange-traded derivatives, contracts traded *(2010)*	6	● 32	2	1	9	1	*nil*	49
Interest rates OTC derivatives turnover *(April 2010)*	● 46	24	3	7	2	1	3	14
Fund-management assets *(End 2010)*	8	● 47	7	6	2	1	*nil*	29
Hedge-fund assets *(End 2010)*	19	● 68	2	1	*nil*	2	1	7
Private equity, investment value *(2010)*	21	● 53	1	4	1	*nil*	1	19

Source: TheCityUK

A swarm of rules from Europe

A more worrying threat to London's financial district is posed by a swarm of new regulations being devised in Brussels and farther afield. Many of these rules will hobble all of European finance, not just the City; but because the City is the centre, it will suffer most.

Most pernicious of all is a proposed financial transactions tax, which would levy a small charge on transactions involving financial institutions based in the European Union. The tax aims to raise money (the EU thinks it could fill its own and national coffers with as much as €55 billion a year, some 60-70% of which would be collected in Britain) while also discouraging the trading and speculation that many European politicians blame for the financial crisis. The European Commission's own impact assessment reckons that it could force 90% of some sorts of trading activity simply to move from the E U, with the loss of hundreds of thousands of jobs. Such a tax could not be imposed on Britain, however, without its consent.

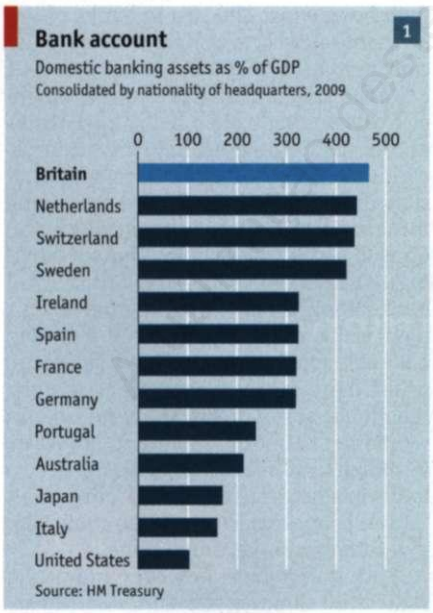
Another European threat to London comes from proposals that would force clearing houses that handle euro-denominated derivatives to be based within a country that uses the euro. Combined with rules forcing O T C derivatives onto exchanges and clearing houses, these rules would threaten a market that Britain dominates, to the benefit of centres such as Paris or Frankfurt. They are, however, such a blatant violation of Europe's single market that they are unlikely to survive.

The more insidious threat facing London's financial-services industry comes from a thousand smaller regulatory hurdles that will make it incrementally more difficult or expensive for financial firms to conduct business or enter new markets. The number of new rules is staggering, as is their reach. Some, such as Europe's proposals to bar national regulators from forcing banks to hold more capital than the European standard, would in fact weaken regulation of British banks. Others may prevent European fund mangers from buying the assets they choose, or prevent the use of ratings produced by the foreign branches of rating agencies. Many are also at odds with one another. One set of rules is intended to press banks to issue more long-term bonds. But another set of rules aimed at insurers, traditionally the biggest buyers of these bonds, will penalise them if they hold them.

These sorts of muddles in Europe are nothing new. In the past Britain played an important role in improving much of Europe's financial regulation, mainly because the size of its financial markets at home means it has some of the region's most experienced regulators. Yet many bankers in Britain now fret that a row in December 2011, when David Cameron, the prime minister, threatened to veto changes to EU treaties, has reduced its influence in Brussels. "Anything we argue for now will be ignored on principle," says one banker.

The cumulative impact of all these rules is difficult to assess. But when they are combined with a 50% tax rate on higher incomes introduced in 2010, curbs on the immigration of skilled employees and regular tongue-lashings delivered against finance by politicians and policymakers, they will probably weigh against financial firms moving to or expanding in London when other financial centres beckon. On a rough calculation for The Economist by KPMG, getting out of London would be advantageous for high earners (see chart 2).

Tighter regulation is not the City's only headache. It is also battling with falling demand for its services in its main markets. The economic funk in Europe and America has meant that the industrialised world's equity markets have been fairly moribund. The immediate outlook for trading, capital-raising, merger deals and for the fees they yield to City firms is the worst it has



• arguably been for decades.

Finance grew fat during the rich world's long credit expansion, and it is inevitably shrinking now that boom has turned to bust. The share of Britain's G D P accounted for by insurance and finance, including retail services like arranging mortgages, has already dropped to just under 8% from above 9% in 2007. The number of people employed by the industry in Britain fell by 7% in the three years to the third quarter of 2011 More jobs losses are likely as the City adjusts to a gloomier economic outlook and the pressure on revenues.

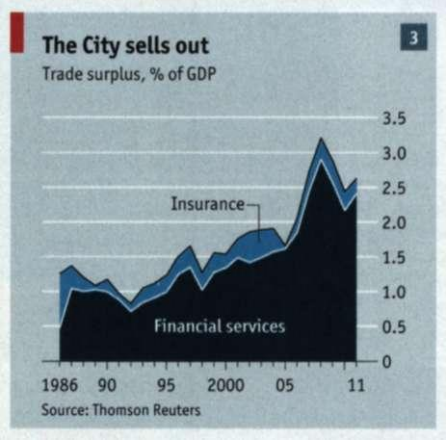
There is a broader threat to the City's status as a financial hub: it may struggle to remain relevant when the biggest engines of economic growth are half a world away. The shift in global economic power to the big emerging countries in Asia means prospects look much brighter for the newer breed of financial hubs, such as Hong Kong and Singapore, than for established centres like London or New York.

London has hung on to its top ranking in the closely watched Global Financial Centres Index published twice a year by z/Yen, a consultancy. But the gap between London and New York, in first and second place, and Hong Kong and Singapore in third and fourth has narrowed in recent surveys. This has sharpened the anxiety among some City folk that the Asian upstarts will not only capture the lion's share of the fast-growing demand for finance on their doorstep, but will also take a big bite out of London's established businesses.

The City is not helpless in meeting this challenge. Incumbency is a powerful barrier in industries, such as finance, where there are strong network effects. Trading attracts liquidity and thus more trading. A steady supply of skilled financiers adds to the virtuous circle.

The use of English around the world gives London an edge over other European centres. London goes to work in the middle of the global trading day: the City day starts just as Asia's financial markets are closing and its financiers are still at their desks when the New York market opens. That makes it an ideal spot for global asset managers. One-third of the £4.8 trillion of funds managed in Britain is on behalf of foreigners, according to TheCityuK. London is also an ideal place to strike deals between parties from different countries, because of its highly respected body of commercial law and experienced judges.

London's lead in foreign exchange, as well as in interest-rate derivatives, grew out of its reinvention in the 1960s and 1970s as an offshore centre for dollar deposit-taking and lending, after sterling's decline as a reserve currency. When the Bretton Woods system of fixed exchange rates broke down, London was quick to establish itself as a venue for trading currencies and hedging the risk of floating exchange rates.



Twice as much foreign-exchange trading goes on in London as in New York and Tokyo combined. Having staked out this ground early and occupied it for so long, London would be hard to dislodge.

All this suggests that finance is not quite as mobile as some of its practitioners like to pretend. So far, only a few finance outfits, mostly hedge funds or commodity traders, have moved (usually to Switzerland) to escape higher taxes, onerous regulation and public hostility. The best hedge-fund traders are often contrarian thinkers, who might benefit from distance from the crowd. Not every business is quite as footloose. For outfits that raise capital and sell securities, it is much harder to operate efficiently at a distance from clients and complementary businesses.

Still, even long-established clusters are vulnerable to challenge. Some City bigwigs worry that a series of marginal decisions to locate business in other financial centres will add up over a decade to a loss of critical mass.

The financiers who make up the City's senior ranks, many of them from outside Britain, began their careers in London in the 1980s, around the time of the Big Bang reforms. They are now middle-aged, are attached to London, have children in schools and may be reluctant to up sticks for the sake of a keener tax deal. But high taxes and restrictions on immigration from outside the European Union may prove a bar to a new generation of financiers seeking their fortune in London (though the City has secured derogations from the government's cap on non-EU migrants). If today's M B A graduates from Mumbai or Seoul are put off coming to London by high taxes, they are scarcely likely to consider the City as a place to expand when they eventually become the bosses.

Why the City matters

Should Britain's policy brass worry if London loses out to other financial centres? After such a catastrophic financial crisis, it is tempting to let the City go quietly into decline. Senior politicians have stressed the need to "rebalance" the economy away from financial services towards high-end manufacturing, where Britain has a toehold. The notion that the economy needs more real engineering and less of the illusory financial sort appeals to many.

But neglect of the City is at odds with the need for another sort of rebalancing. Domestic demand is likely to be scarce for many years in Britain as consumers tackle their debts and the government battles to narrow its budget deficit. That will leave the economy ever more reliant on export earnings. And finance is one of the areas in which Britain is a global leader.

The City's competitive edge is reflected in Britain's balance of payments: the combined trade surplus in financial services and insurance was 2.6% of G D P in the first three quarters of 2011 (see chart 3). If the exports of related business services—such as law, accountancy and management consulting-are included, the surplus rises above 3% of G D P . This export prowess is unmatched by any other financial centre. New York has always been able to fall back for custom on the vast American market. But London, as the capital of a declining economic power, has for decades been forced to look outward for business.

This means Asia's rise should be as much an opportunity as a threat. China, India and some other big emerging economies have immature financial markets, whereas Britain has a long-established expertise in finance. Economic logic suggests there ought to be gains from trade between the City and the emerging giants. Having established itself as a global hub for dollar financing, it makes sense that the City is bidding to be an offshore centre for the yuan, as it becomes a more serious challenger to the dollar as a global currency.

London may well become a hub for this new trade. Yet the flow and wash of finance can be fickle. And the slow trickle of threatening regulation from abroad, as well as at home, may still in the end leave the City high and dry. •

Fonte: The Economist, London, v. 402, n. 8766, p. 19-22, 7 a 13 Jan. 2012.