twentytwentyvision

20 years of the Financial Services Survey

The future of financial services

CBI
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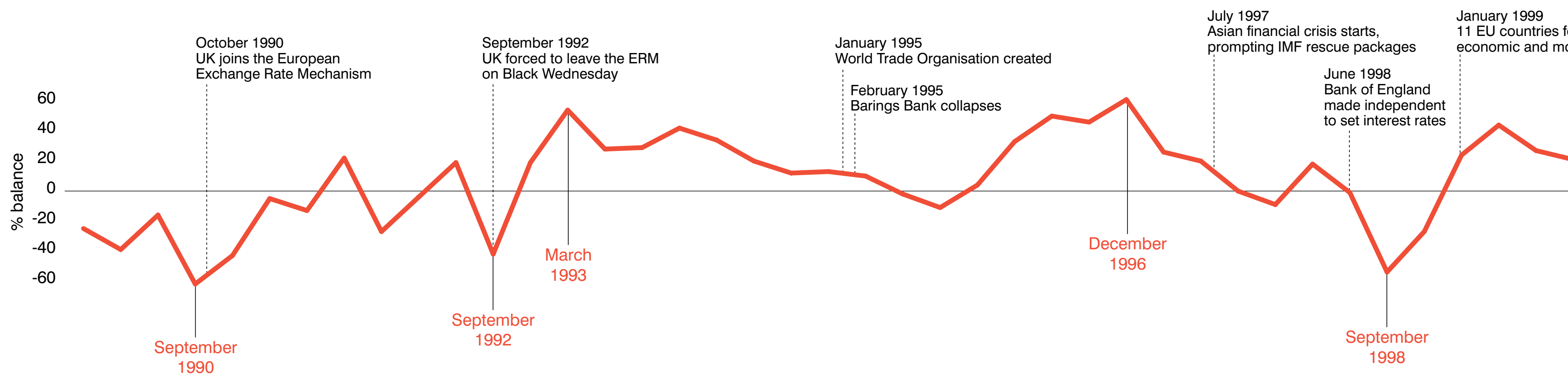
20/2

Highs and lows in the optimism results



September 1990

Within nine months of its launch, the CBI/PricewaterhouseCoopers Financial Services Survey recorded the greatest degree of pessimism about the business situation in the whole 20 years. Only 3 per cent of those surveyed were more optimistic about the future, compared with 65 per cent who were more pessimistic – an optimism balance of -62.

1990 was a year in which house prices started to fall across the UK for the first time in decades (recovering only in 1993). The UK economy had begun to contract in July, the start of a recession that lasted five quarters. The FTSE 100 index, which had slowly recovered to the peak reached before 'Black Monday' in 1987, dropped sharply and ended the year 12 per cent below its level at the start of the year. The gloom sparked by the recession that began in 1990 was slow to lift, continuing into the following quarters.

September 1992

Tentative recoveries in sentiment in 1991 and early 1992 were reversed sharply in the run-up to sterling's exit from the European Exchange Rate Mechanism on Black Wednesday (16 September), when optimism troughed at –42. The fall reflected a decline in business volumes and slowing profitability growth. The gloom came after weak GDP growth in the first half of 1992, with a small (0.2 per cent) decline in the second quarter. House prices had fallen consistently throughout the year, dropping particularly sharply between August and September. Mortgage repossessions remain close to unprecedented levels while corporate insolvencies hit a record high – largely the consequence of high interest rates.

At the heart of the sluggish economy lay the problem of membership of the ERM. Interest rates were kept in double figures as Germany struggled to deal with the post-reunification inflationary boom. An economic stimulus was needed, but was impossible without leaving the ERM, which the government refused to contemplate. When sterling was forced out, it was seen as a catastrophe for the UK economy, but Black Wednesday marked a turning point.

March 1993

The rebound in optimism after Black Wednesday was relatively quick: the balance turned positive in the final quarter of 1992, reaching the second highest peak in the survey's history in March 1993 – +54. Interest rates had fallen sharply at the end of the previous year, and somewhat stronger GDP growth was recorded following a sluggish 1992. Share prices had begun to recover from August 1992 and the FTSE 100 climbed steadily in the first quarter of 1993.

The positive sentiment reflected strong expectations of growth in business volumes and profitability for the following quarter. Interest rate spreads had also widened significantly, boosting profitability.

December 1996

Optimism began to strengthen in December 1995 and peaked at +61 a year later, after the fastest rise on record to date. By December 1996, those saying they were more optimistic about the future outnumbered those who were less optimistic by 13 to one. The same survey found record increases in income, business with private individuals and business with overseas customers – all contributing to a peak in profitability.

Sterling had appreciated strongly in the second half of 1996, equity prices had been on an upward trend over the same period and house prices had resumed their growth. The growth in business volumes over the quarter had also been the fastest on record, at +79. The strength of activity had been broadly mirrored across all the financial services sectors, particularly in banking and building societies, which had also seen record rises in business volumes.

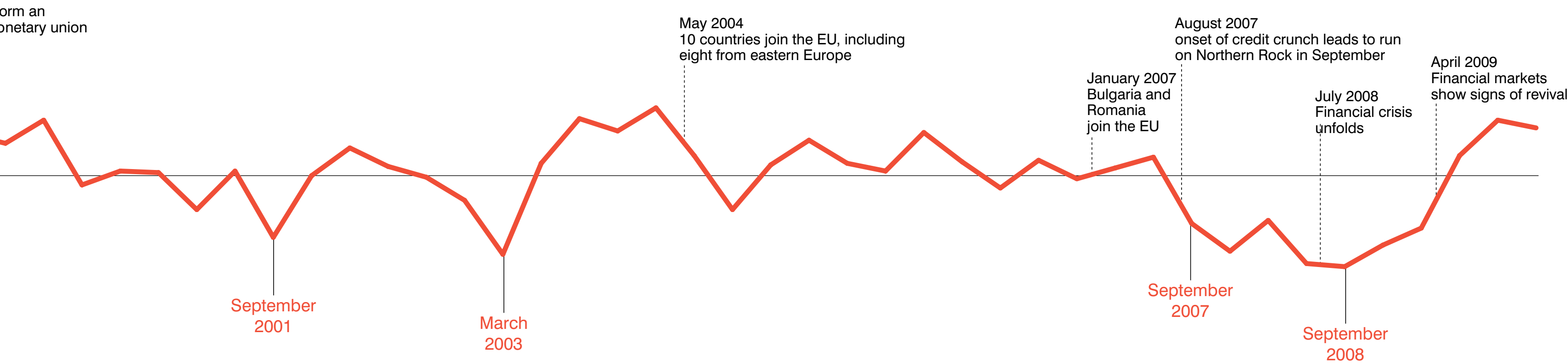
September 1998

The trend in optimism weakened after its 1996 peak, hitting a low of -54 in September 1998. Growth in business volumes and income values had held up well over this period, but confidence had been hit by shocks to the global financial system, such as the Asian financial crisis that began the previous year and the Russian debt crisis of August 1998.

Optimism fell sharply in all the financial services sectors, particularly in investment management, which recorded its steepest fall up until that date. With slowing growth in business volumes expected to turn negative in the next quarter, the sector was caught between predictions of falling income and operating costs that were rising markedly.

September 2001

The survey for the third quarter of 2001 was largely completed by the time of the terrorist attacks on America on 11 September 2001, but confidence was



already fragile, with optimism hitting a low of -40. The dot-com collapse of 2000–01 had led to significant falls in major stock-market indices from 2000 to 2003 and, while there was no recession in the UK, the US economy had been in recession since March.

The fall in sentiment was reflected across most of the financial services sectors, with only slight rises in business volumes after much stronger increases over the previous four years. Fee, commission and premium income also fell slightly in this quarter after strong growth previously – leaving profitability flat.

The sharpest fall in optimism – hardly surprising given falling stock markets – was in securities trading, with no respondents reporting positive sentiment over the quarter. Business volumes and income values declined markedly, while profitability fell sharply.

March 2003

Eighteen months after 9/11, the dot-com bust had taken the FTSE 100 down by almost 50 per cent since its peak in 1999. It reached its lowest level since 1995 in January 2003, when equity markets began to strengthen. Sterling started to appreciate from the middle of the year, when interest rates also hit a 48-year low at 3.5 per cent.

Optimism had initially strengthened after September 2001, but began to see a slower increase in June 2002 and troughed at -51 in March 2003. This appears to have been linked to narrowing of spreads in most sectors around this period.

The overall fall in optimism was reflected in the different sectors, most strongly among building societies where sentiment was overwhelmingly negative. This was linked to a significant fall in profitability as house price inflation began to ease after peaking at more than 25 per cent year-on-year.

September 2007

The survey for the third quarter of 2007 was carried out before the run on Northern Rock, but there had already been a severe decline in sentiment after two relatively steady years. The tightening of global credit markets was already causing anxiety for many, with banks and building societies among the most – but not the only – concerned sectors.

The FTSE 100 had peaked in June at 6732.4, as had Halifax house price inflation at 12 per cent year-on-year in July. Sterling had begun to trend downwards from its high in January 2007, and 3-month LIBOR peaked at 6.85 per cent in this quarter.

Optimism fell sharply from +12 in the previous quarter to -31, and continued on down to reach bottom at -49 in December. The drivers were slower growth in business volumes and negative expectations across all the major indicators for the coming three months.

Similar trends from positive to negative were seen in all the financial services sectors and the decline in already falling sentiment accelerated in building societies and insurance broking. Optimism stayed negative in banking for the next eight quarters, with marked falls in business volumes and fee, commission and premium income.

September 2008

After a shallower fall in sentiment in the first quarter of 2008, pessimism grew in the third quarter – even before the banking crisis that dragged down Lehman Brothers, Bradford & Bingley and HBOS among others. The impact of the credit crunch had begun to hit the real economy, with the UK entering recession in the second quarter: GDP declined 0.1 per cent in the second quarter and 0.9 per cent in the third. Equities steadily fell in the UK, US and Japan, and LIBOR remained stubbornly high. Sterling, meanwhile, was falling too.

Optimism fell to -59 in September 2008 as all major indicators fell sharply. It remained negative in December 2008 and March 2009, albeit with the rate of decline easing. The major indicators improved gradually across all the sectors in varying degrees, but the UK recession deepened – GDP fell by 2.5 per cent in the first quarter of 2009, the sharpest quarterly contraction since 1958.

Sentiment turned positive in June, however, following the introduction of quantitative easing by the Bank of England and reductions in interest rates to a historic low of 0.5 per cent. LIBOR spreads against both the bank rate and the 3-month gilt repo rate began to trend downwards. Equity prices began to rise after their troughs in March 2009.

Contents

Forewords

A stable and effective financial system is essential to any successful modern economy, and the financial services industry plays a particularly significant role in the economic life of the United Kingdom.

During the past two highly eventful decades, the Financial Services survey has faithfully charted the ebb and flow of industry sentiment. In doing so it has become one of the most prominent and closely observed barometers of financial services in the UK. I am delighted that PricewaterhouseCoopers has been associated with the survey since its inception.

As this report makes clear, the turmoil of the past 18 months has presented the industry with an additional range of future challenges and opportunities. These include public hostility and political scrutiny, the strengthening of new financial centres in Asia and new regulation. London retains many of its historic advantages, but financial services is becoming increasingly globalised. Continuing to attract and retain talent and capital will be essential if the UK industry is to maintain its leading role.

In this environment, PricewaterhouseCoopers is working hard to assist all of our financial services clients. Our role in the creation of the UK Asset Protection Scheme and our administration of Lehman Brothers International are just two high profile examples of our involvement.

The UK financial industry is certainly living in interesting times. Whatever the future holds, the Financial Services Survey will continue to chart its progress. I look forward to it.

Ian Powell

Ian Powell
Chairman and Senior Partner
PricewaterhouseCoopers LLP

From its launch in 1989 right up to the present day, the Financial Services Survey has remained the only one of its kind devoted solely to the financial sector. And through the long-term support and partnership of PricewaterhouseCoopers, it has evolved and matured into a key data release for analysts and policy makers alike.

Activity in the financial services sector can be very difficult to quantify and, although much work has been undertaken by the Office for National Statistics over recent years to improve the data available, official figures remain volatile and subject to quite drastic revision. As a result, qualitative data of the kind produced in this survey are perhaps even more vital for financial services than any other sector. Sitting as I did on the Monetary Policy Committee during a time when financial services were becoming an increasingly important part of the UK economy, such information was invaluable.

However, for some commentators it has taken the events of the last few years to bring home the real importance of this survey. Being one of the first indicators of troubles in the financial sector back in 2007, it has earned a place as one of the most keenly watched surveys during the recent downturn. And with evidence of how events in financial markets can ripple through to the real economy now very much entrenched in people's minds, I am confident it will remain an important indicator for another 20 years.

Richard Lambert
Director-General
CBI

20/20 Vision: Executive summary

The CBI/PricewaterhouseCoopers Financial Services Survey has reached its 20th anniversary, having lived through the second half of the long bull run that ended in 2000–01, two stock market peaks and the most serious financial crisis in living memory. This report evaluates the survey's performance since its launch at the end of 1989, and looks at the prospects for the financial services industry over the next 20 years.

The report starts with a summary of the results of the survey during its first 20 years, which illustrates its unique ability to chart trends and predict future prospects in the industry. The accompanying analysis shows that it has a remarkably good record in anticipating key official data – for example, proving reliable in predicting turning points on employment levels ahead of official data.

Turning to the next 20 years, the report looks at what the future holds for the financial services industry as it emerges from the deep crisis that began in 2007. Based on the views of experts at the CBI and PwC and interviews with 20 leading figures in and around the industry, it provides a vision of where the industry is going and the challenges it will face over the next two decades.

The key messages include:

- **Global banking** will continue to be dominated by a few large institutions – mainly universal banks. There will be more consolidation of banks internationally, with Chinese banks starting to appear in the top 10.
- **Investment banking** – with casualties among the biggest global investment banks during the financial crisis, new competition will emerge from hedge funds and boutique advisers.
- **UK banking** could see the emergence of new competitors, with consolidation of smaller organisations and the restructuring of state-supported banks.
- **Building societies** could play an enhanced role in retail banking through continuing mergers, so long as obstacles created by the way they are regulated can be removed.
- **Asset management** – Britain will remain an important centre for asset management. However, the EU Alternative Investment Fund Managers Directive poses a threat to London as a European centre for hedge funds and private equity.
- **Insurance** will see further consolidation, though post-crisis capital requirements could weigh the sector down. There is scepticism in the sector about whether government moves to increase savings will achieve their objectives.
- **Financial products** will become more transparent, with innovation having to fight to prove its worth.
- **Sustainability** – there will be pressure on banks and other sectors to move away from a focus on short-term performance.
- **Government intervention** and tougher regulation will continue, with continuing international coordination of measures to avoid a repetition of the financial crisis.

- **Risk management** – regulators will refine capital adequacy rules by setting risk-adjusted requirements for particular activities. This will make some activities less attractive.
- **London's role** as a financial centre has not been damaged by the crisis so far, and the UK has retained its competitive advantages in financial services. But excessive or inappropriate regulatory measures will make the UK less competitive for financial services.
- **Tax rises** that appear to be politically motivated and which are not temporary will drive firms and individuals out of London and deter overseas financial services organisations from expanding in the UK or choosing London as a location.

All of this will take place against a background in which the global economy's centre of gravity continues to shift eastwards. The industry will therefore focus future investment on China and other Asian markets, as illustrated by recent announcements from HSBC and Fidelity International. As a consequence, strengthening financial centres in Asia and elsewhere will increasingly challenge established centres such as London. The UK has all the advantages needed to retain its global pre-eminence in financial services, but it will have to work hard to maintain its attractions for an industry whose firms and talent are internationally mobile.

The 20/20 contributors from the financial services industry

Philip Augar, Journalist and former investment banker

Barry Bateman, Vice-Chairman, Fidelity International

Graham Beale, Chief Executive, Nationwide Building Society

Tim Breedon, Chief Executive, Legal & General Group

Peter Clarke, Chief Executive, Man Group

Maggie Craig, Acting Director General, Association of British Insurers

Stuart Fraser, Chairman of the Policy & Resources Committee, City of London Corporation

Stephen Green, Chairman, HSBC Holdings

Mark Hodges, Chief Executive, Aviva UK

Michael Kirkwood, Chairman, Ondra Partners, and Non-Executive Director, UK Financial Investments

Angela Knight, Chief Executive, British Bankers' Association

Lord Levene, Chairman, Lloyd's of London

Sir Andrew Likierman, Dean of the London Business School

Jonathan Moulds, President of Bank of America Merrill Lynch for Europe, Middle East & Africa

David Nish, Chief Executive, Standard Life

Michael Spencer, Chief Executive, ICAP

Gillian Tett, Assistant Editor, *Financial Times*

Lord Turner, Chairman, Financial Services Authority

John Varley, Chief Executive, Barclays Group

Simon Walker, Chief Executive, BVCA

The CBI/PwC Financial Services Survey: The first 20 years

Born shortly after the fall of the Berlin Wall in December 1989, the CBI/PricewaterhouseCoopers Financial Services Survey has lived through eventful times for the industry. While it was still in the cradle, sterling joined the European Exchange Rate Mechanism (ERM) in October 1990 – only to crash out less than two years later on Black Wednesday. Its first decade was spent in the long stock-market bull run that ended with the dot-com crash when it reached adolescence in 2000. And as it approached adulthood, the credit crunch in the autumn of 2007 tipped the world into the deepest financial and economic crisis since 1929.

The impact of such rites of passage on the financial services industry can be seen in the quarterly figures on optimism levels recorded by the survey over the last 20 years (see inside front cover). They show considerable volatility, with constant ups and downs, in some cases quite radical movements over short periods. However, the peaks and troughs in sentiment mostly reflect external events that have had a significant impact on the business performance of the firms in the survey – such as house price movements, economic growth figures and interest rate changes, as well as financial shocks.

The first three years of the survey, for example, saw pessimists outnumbering optimists most of the time. The UK economy had begun to contract in July 1990, with falling house prices and the onset of a recession that lasted five quarters. But it was the entry of sterling into the ERM in October 1990 that prevented monetary policy from responding to the downturn. Worse, interest rates were stuck in double figures because Germany, the ERM's anchor economy, was trying to deal with the inflationary boom created by reunification following the fall of the Berlin Wall.

Sentiment plummeted in the third quarter of 1992 as the crisis deepened in the run-up to Black Wednesday. At the time, the departure of sterling from the ERM on 16 September was seen as a severe setback for the economy, yet it was followed by a sharp rebound in optimism measured by the survey. Confidence became reality in the ensuing recovery, with a hefty fall in interest rates helping to boost growth. For most of the next five years, optimists comfortably outnumbered pessimists as stock-market indices continued to climb and house prices resumed their growth.

Events far beyond the UK could also affect sentiment in the industry. The Asian financial crisis that began in 1997 and the subsequent Russian debt crisis of August 1998 hit confidence, taking optimism to its lowest figure since the start of the decade. When the impact of both crises was seen to be largely limited to the affected regions, recovery was even faster.

The dot-com collapse of 2000–01 predictably hit optimism, as share prices began a two-year decline and the US – though not the UK – slipped into recession. Confidence reached a trough in September 2001, according to the third-quarter survey which had largely been completed by the time of the terrorist attacks on America. Despite the damage inflicted on confidence in the US, there appeared to be no lasting impact from 9/11, with the survey recording strengthening sentiment in the next two quarters.

The continuing stock-market falls did, however, take optimism down to a further low point in March 2003. Thereafter, optimism was again the order of the day until September 2007, when the credit crunch hit the world's financial markets. Seven quarters of gloom followed, with only a brief upturn in sentiment – still deeply negative – in March 2008. This was quickly reversed as the impact of the financial crisis deepened over the summer, with the unfolding of the banking crisis that then brought down Lehman Brothers, Bradford & Bingley and HBOS among others. September 2008 saw the second lowest optimism balance in the 20 years of the survey, and it was only in June 2009, after confidence returned to the stock markets, that optimism in the financial services industry again appeared to outweigh pessimism.

The first two decades of the Financial Services Survey have certainly not lacked drama. But what would a report card say of its progress during this period?

First, it would be awarded high marks for its success in tracking the business vitality of the financial services industry. Rising optimism in the survey has been a good indicator of improving business conditions that feed through in terms of output, employment and profitability. Deepening gloom has been a warning that the business environment for the industry is deteriorating.

Second, the banks would be scored as the most influential sector in the industry. Given their weighting in the survey and their central role in financial services, gloom among bankers quickly spreads across the industry – as does banking exuberance when times are better. Banking and the industry as a whole have moved along very similar paths on sentiment over the 20 years of the survey, though bankers tend to be more optimistic at the highs and more pessimistic at the lows than the industry overall.

Third, the survey has a very good record of tracking key official data. For example, it has proved less volatile in reporting the volume of business than official data which rely on hard-to-measure flows and are prone to revision. It also has a good track record on employment levels, often predicting turning points ahead of official data – especially in recent years.

The CBI/PwC Financial Services Survey has thus reached adulthood with an enviable record of achievement in measuring the health, perceptions and plans of the industry. The next 20 years are likely to be no less challenging than the last two decades, and the survey will remain an essential weathervane for those who wish to know which way the wind is blowing in the industry.

About the survey

The CBI/PricewaterhouseCoopers Financial Services Survey, launched in December 1989, offers up-to-date insight into recent trends and future prospects in financial services quarter by quarter. It covers a broad range of financial services activities, including banks, building societies, investment managers, securities traders and the insurance industry.

The first question each quarter asks the participants whether they have become more or less optimistic about the situation in their sector, providing a unique indicator of sentiment in the industry. Subsequent questions ask about the trend for the last three months in the value and volume of business, charges, costs, profits, employment and training – and the expected trend in these indicators over the next three months. Participants are also asked about factors likely to limit their ability to expand business over the year ahead, whether they regard business as above or below 'normal', their investment intentions over the coming year, the reasons for planned expenditure and likely constraints on it.

The survey responses are weighted according to the size of the company and the importance of its activity within the industry. And in keeping with other CBI surveys, the results are often presented by using the balance figure – the percentage of respondents replying 'more', 'above normal' or 'up', minus the percentage replying 'less', 'below normal' or 'down'. It should be noted, however, that this provides a relative measure of the results, not an absolute one: if optimists outnumber pessimists when asked about the situation in their sector, this does not mean that participants are full of optimism – merely that they are more optimistic than they were.

20/20 Vision: The future for financial services

The future of the financial services industry has rarely been under greater scrutiny than over the last two and a half years. The deep financial crisis that followed the credit crunch has raised fundamental questions about the role of the banks in particular, but other sectors have not escaped criticism. A lively debate continues to rage on the regulatory response to the crisis and on measures needed to avoid a repetition.

So what is the outlook for the industry over the next 20 years of the CBI/PricewaterhouseCoopers Financial Services Survey? To find out, we consulted experts at PwC and the CBI about how they saw the future, drawing on work already published by both organisations on the impact of the crisis on the financial services and business.[1] Then we conducted interviews with 20 leading protagonists in the debate, both within the industry and outside it, and from all the main financial services sectors. We are grateful to them for agreeing to be part of this project and for giving so generously of their time.

There was, of course, no consensus about the future, though there was a surprising level of agreement on many issues. What follows is a distillation of the views expressed – *a 20/20 Vision for the future of financial services.*

The impact of the crisis

While the interviews focused on the future, it was important to begin with the impact of the crisis on the industry as a whole. None of the individual financial services sectors had been untouched by the events of the last two and a half years, but the impact on them had varied enormously.

The banks, unsurprisingly, had taken the biggest hit – with well-known names disappearing from the high street, the survivors forced to raise large amounts of capital and the sector struggling to rebuild its reputation in the court of public opinion. The financial environment had improved in 2009, with significant capital-raising and strong performance in debt markets producing a surge in business for investment bankers and wholesale banks. But as Jonathan Moulds, President of Bank of America Merrill Lynch for Europe, the Middle East & Africa, acknowledged in his interview, this surge followed action by central banks to pump in tremendous amounts of liquidity – liquidity that will be withdrawn at some point.

At the other end of the spectrum, the British insurers had emerged relatively unscathed. The value of their investments in shares and property had plummeted, and demand for some insurance

1 *The day after tomorrow: A PricewaterhouseCoopers perspective on the global financial crisis*, PwC, February 2009.
The Shape of Business: The Next 10 Years, CBI, November 2009.

products had slipped as risk-averse consumers diverted resources to reducing their debts. Falling interest rates also made life harder by increasing the pension liabilities of the life insurers. Yet according to Lord Levene, Chairman of Lloyd's, which accounts for more than half the non-life insurance market in London: *'It has been business as usual. Clearly investment income has been affected, but we're in good shape.'*

The economic legacy of the crisis will be long lasting, however. A study by the International Monetary Fund[2] found that recessions associated with financial crises had historically been longer and deeper than those caused by other factors. Nor will the recovery be helped by the ending of what Mervyn King, the Bank of England Governor, described as the NICE decade – the period that was 'Non-Inflationary Consistently Expansionary'. Life will be harder for everyone in financial services in the next few years.

The future shape of the financial services industry

The individuals interviewed for this report all foresaw significant changes ahead in the shape of the UK financial services industry – though some of the industry's critics thought they were unlikely to be enough. Those at the helm of financial services organisations, however, believed that their business models would survive and prosper in this changing world. Since the individuals concerned all led organisations that had survived the crisis without excessive damage, this was perhaps to be expected – though all also admitted to fears about the immediate future that we will return to later.

Among the bankers, there was a belief that their sector globally would continue to be dominated by a few large institutions with the reach and depth to provide services to corporate clients operating around the world. These would mostly be the universal banks with the strongest capital bases, able to offer a full range of services to individuals and businesses because they had invested in the infrastructure and technology necessary to meet changing demands in the digital age.

This may seem counter-intuitive, given the widespread doubts about complex banks that are too big to fail. But John Varley, Chief Executive of Barclays Group, said that the experience in the crisis had been that it was largely the less complex banks that had failed – specialist mortgage lenders and pure investment banks. *'Large banks are complex to manage, but not intrinsically unmanageable,'* he said – reeling off a list of banks including his own that had stayed profitable despite suffering setbacks in the crisis.

There were two views on whether those banks would become larger still. Critics of the industry such as Philip Augar, the former investment banker turned author, expected a pause in the push for scale: *'It will be hard for big companies to make the case to their shareholders that they need to be doing everything everywhere.'*

But Mr Varley said the industry remained fragmented globally, with the top 20 banks having a market share of around 25 per cent – far lower than in industries such as pharmaceuticals. The requirements of customers were already fairly

2 *World Economic Outlook*, IMF, April 2009.

homogeneous in wholesale banking and were now converging in retail banking as well. *'We will see a smaller number of banks playing a bigger part in the global industry over the next 20 years.'*

Consolidation would be driven partly by increased regulation, said Angela Knight, Chief Executive of the British Bankers' Association. *'The very fact that regulation is becoming more costly means the barriers to entry will rise, but consolidation can help keep the price down for customers.'*

There was also agreement that some new names would be appearing in the top 10. *'In the next five to 10 years, we can expect the emergence of new Asian competitors, particularly from China,'* said Stephen Green, Chairman of HSBC Holdings. *'The biggest ones are already opening offices in the main financial centres, as they follow their own domestic customers abroad.'*

Mr Green saw another reason to expect China to become a global banking power, as smaller economies felt increasingly uncomfortable over allowing their banks to grow too big in relation to their fiscal resources. *'The majority of the top 10 banks in five years' time will come from one of the two jurisdictions capable of hosting very large institutions – the US and China.'*

The remaining big investment banks were also seen as survivors, if only because of their global distribution power when handling issuance of debt and equity. However, additional capital requirements for what were seen as riskier business lines could see some activities such as proprietary trading moving outside the banking sector to competitors which already have the necessary technology. *'I wouldn't be at all surprised to see a new class of institution coming out of the hedge fund or private equity sectors to fill the void left by the old stand-alone investment banks that have now been swallowed up,'* said Philip Augar.

Jonathan Moulds of Bank of America – which owns one of the world's largest investment banks in Merrill Lynch – acknowledged the potential for hedge funds to move into the sector. *'In parts of the trading businesses, technology now plays a key role and some of the alternative players like the hedge funds have excellent infrastructure and technology. They increasingly have the ability to compete in sectors such as algorithmic trading, certain types of flow derivative and foreign exchange trading. As the market moves towards more central clearing, that levels the entry playing field.'*

Peter Clarke, Chief Executive of Man Group, could also see the possibility of convergence between hedge funds and investment banks. The talent that sat in investment banks' proprietary trading operations could move into the investment management business, he said – adding that the hedge fund model was better: *'It makes money for investors, not the shareholders of the investment bank.'*

He believed the hedge fund sector would increasingly be defined not as an asset class, but as a flexible investment strategy that used leverage and which could be applied in many different situations. Unlike a traditional long-only investment manager hedging against share indexes, hedge funds could hedge against a variety of risks such as volatility and equities as a class.

Others envisaged the emergence of more boutique advisers, drawing on the pool of investment bankers cast adrift by the collapse of some big firms during the credit crunch. But Gillian Tett, the *Financial Times* Assistant Editor whose recent book[3] identified herd behaviour as an important factor in creating the financial crisis, said she feared that a greater diversity of institutions was unlikely to develop. *'We need a more multi-faceted ecology in banking. What I fear will happen is that we will end up with a few big players, where risk remains concentrated.'*

When it came to UK retail banking, the consensus was that the big five banks (Barclays, HSBC, Lloyds Group, RBS, Santander) and Nationwide Building Society would continue to dominate the market. But there were varying expectations about the likelihood of new organisations entering the market – and their ability to create sustainable positions.

'There is potential for one or two new mid-sized players to emerge,' said Michael Kirkwood, Chairman of Ondra Partners and a non-executive director of UK Financial Investments, the body responsible for the government's investments in RBS, Lloyds, Northern Rock and Bradford & Bingley. He listed several assets that could contribute to creating new competition, including the divestments the European Commission had demanded from RBS and Lloyds in return for state support. The 'good bank' part of Northern Rock could play a role in restructuring once it was returned to private ownership, as could the two UK subsidiaries of National Australia Bank – Yorkshire and Clydesdale – either under continuing NAB ownership or as part of a new group.

Graham Beale, Nationwide Chief Executive, saw the possibility of an enhanced role for mutuals in the UK market. The merger of The Co-operative Bank and Britannia Building Society had created a stronger contender, as would the combination of Yorkshire and Chelsea building societies. *'I think there is a genuine desire among the tripartite authorities to create a second or even a third big-ticket mutual.'*

Some of the smaller mutuals might also explore ways to work together in raising capital, sharing services and dealing with regulatory requirements, he added. *'There are European mutual models such as Rabobank [of the Netherlands], which is a collective of something like 150 institutions. We're at a very early stage of exploring opportunities in the UK to mirror such arrangements.'*

There was a widely held expectation that organisations from outside the industry could venture more deeply into financial services, with Tesco and Virgin frequently mentioned. Adair Turner, Chairman of the Financial Services Authority, said it would be valuable to have new entrants in what was quite a concentrated market, but warned that entry was difficult. *'Extending credit to small businesses, for example, requires a specific set of skills which are not easy to develop.'*

Lord Turner also pointed out that some of the biggest casualties of the credit crunch had been new entrants, such as the demutualised building societies which had tried to capitalise on deregulation to grow bigger.

3 *Fool's Gold: How Unrestrained Greed Corrupted a Dream, Shattered Global Markets and Unleashed a Catastrophe*, Gillian Tett, Little, Brown, April 2009.

Insurance

While the insurance industry emerged relatively unscathed from the crisis, its top executives had concerns about regulatory overkill that would damage their particular businesses. *'Insurers aren't banks,'* said Tim Breedon, Chief Executive of Legal & General.

The sector had been unlucky in that the new EU Solvency II Directive for insurers was coming so soon after the crisis, amid a general assumption that more capital was needed in all financial services companies. *'That was certainly true of banks, but insurers don't have the leverage or the liquidity risk,'* he said. Being required to hold '*excessive and redundant levels of capital*' would put up costs and reduce the value of pensions – and make it more likely that capital would be deployed outside the EU.

Mark Hodges, Chief Executive of Aviva UK, had a similar worry: *'There is a fear in the insurance sector that we're being swept along on a tide of banking regulation, so we're advocating proportionality and recognition of the difference between banks and insurers.'*

In theory, the new Personal Accounts to be introduced from 2012 to bolster long-term savings should offer attractive opportunities to insurers. However Maggie Craig, acting Director General of the Association of British Insurers, said the industry was concerned over several aspects of the scheme – including fears that it could lead to employers reducing their pension contributions to the 3 per cent minimum for Personal Accounts.

'The problem is that the government is setting no targets for pension savings. We have targets for eating five portions of fruit and veg a day and on alcohol consumption, but no-one says how much people should be saving and what they need to save.'

David Nish, Chief Executive of Standard Life, said that although all employees would be automatically enrolled into a pension, it would not be economic for private pension providers to serve the whole market. *'Standard Life will continue to partner employers who want to offer their staff high quality benefits and savings packages.'*

Maggie Craig also saw a threat to the expansion of the long-term savings market in new regulations on retail distribution that will replace commission with fees in 2012. *'If it makes advice so expensive that it pushes it further up-market, that won't do anything for the people left behind. The industry can only stay in the savings market if it has a distribution model that works.'*

There was agreement that the returns from banking would fall as banks reduced their leverage and built up their deposit bases to reduce their dependence for funding on wholesale markets. *'If they have to hold higher levels of capital and liquidity, it is not realistic to expect 20 per cent returns on equity,'* said Mr Kirkwood. *'It was the unrealistic expectations of investors, among other factors, that drove banks to seek profit over prudence. They will still be very profitable, but there will have to be a recalibration of expectations.'*

Turning to other sectors of the financial services industry, London was seen as likely to remain an important centre for asset management, proving an attractive destination for sovereign wealth funds, among others. But there were no expectations of serious restructuring among the UK leaders – most acquisitions recently had tended to be by foreign entrants from North America or continental Europe.

Barry Bateman, Vice-Chairman of Fidelity International, said that when he joined the unit trust sector 28 years ago, there had been about 140 unit trust companies in Britain and he had felt it was ripe for consolidation. But the number of unit trust companies had remained remarkably stable. *'The economist in me says there should be consolidation, but it hasn't happened and I'm sceptical about whether it will.'*

Mr Bateman thought that competition in asset management from outside the industry was equally unlikely. *'There are not many examples of retailers selling investment products successfully, and where we have allowed others to market our funds, it didn't succeed. There is a degree of expertise in investment management that retailers are not seen as able to provide.'*

Among the insurers, there was an expectation of some consolidation of smaller companies and the departure of others. *'The market share of those who do choose to stay here will increase,'* said Mark Hodges, Chief Executive of Aviva UK. Mr Hodges also thought that there could be opportunities that would tempt overseas insurers to invest in the UK: *'There will be prize assets on the block, such as the disposal of RBS Insurance by RBS. That could attract foreign insurers into the market.'*

For the existing life insurers, Tim Breedon, Chief Executive of Legal & General, saw a new role emerging in managing the risks that had built up in the UK pension system, where there was around £1 trillion of final salary pension liabilities.

'The life insurers are extremely well-positioned to help in moving the risk currently on company balance sheets to the capital markets and the insurance sector. We have huge expertise in the science of insurance and banks of data on life expectancy, as well as substantial expertise in managing significant investment management arms and savings businesses.'

David Nish, Chief Executive of Standard Life, said he saw consolidation around different aspects of the life insurance value chain. *'Companies that specialise in managing risk, for example, will need bigger balance sheets. Other companies will see the future in providing investment products and may not wish to support the level of capital needed to take on large-scale risk.'*

Standard Life saw itself as a savings and investment business, he added. *'We may end up selling risk-based products, but might choose not to have the risk on our balance sheet.'*

Lloyd's of London was seen as remaining the largest provider of specialist insurance, with considerable scope for expansion overseas. As its Chairman Lord Levene put it: *'Traditionally our biggest market has been in the US, followed by continental Europe where we could be bigger. The burgeoning eastern markets present another big opportunity, however.*

'China has announced its plans to make Shanghai the country's financial and shipping centre, and as a director of China Construction Bank, I see its very ambitious plans for the future. But I don't think the Chinese will be in competition with us – we want to do a lot more there. It's going to be a very big collaborative exercise.'

This identification of China and the Asian markets as targets for future growth was widely shared in all sectors of the financial services industry. In September 2009, HSBC announced that Michael Geoghegan, its Chief Executive, would be relocated from London to Hong Kong to strengthen its emerging markets focus. *'This not because we are losing confidence in London,'* said Stephen Green. *'It's about where our centre of gravity is, and will increasingly be.'*

In November, Fidelity International announced a similar move, with Anthony Bolton, its star fund manager, shelving his retirement plans for relocation to Hong Kong to start a China-focused fund. *'We see Asia as a faster growth area in the next 10 years,'* said Barry Bateman. *'We will still be investing in Europe, but more of our investment will go into Asia.'*

Customers and products

There was widespread agreement among the interviewees that trust had broken down between key sectors of the industry and its customers as a result of the financial crisis – but some differing views on what was needed to regain their confidence.

One indication of that loss of confidence was provided by recent CBI research into members' views on the response of business to the financial crisis.[4] It found that businesses planned to reduce their reliance on debt financing, which they now saw as a less reliable source of funds. Instead they would expect to reduce gearing by increased retention of earnings, develop forms of supply chain financing (whereby suppliers turn to their customers for funds), and explore alternative sources of funding such as the bond markets, sovereign wealth funds and venture capital.

Stuart Fraser, Chairman of the Policy and Resources Committee of the City of London Corporation, the Square Mile's local authority, said customers would be less inclined to buy innovative products and would move back to basics. *'The degree of complexity will naturally diminish, because the professions were too trusting in accepting products they didn't understand.'*

The pace of innovation had already eased, said the FT's Gillian Tett, adding that it would be some time before customers were ready to buy sophisticated new products. However, the investment banking innovators were still at work, dealing with the restructuring challenges facing the financial sector. *'As for the financial engineers, many have moved into algorithmic trading.'*

Man Group's Peter Clarke said that investors were now suspicious of what he called *'intermediated complexity,'* where products were sold to achieve apparently unconnected aims. *'They want clarity in the proposition and they want proximity to the asset. But they are willing to take on complex trading strategies – complex solutions to complex problems.'*

The need for greater transparency in financial products was a common theme. *'People have lost*

4 *The Shape of Business: The Next 10 Years*, CBI, November 2009.

trust because financial products are complicated to understand and in the past have been sold by people more interested in their own returns – and they frequently haven't delivered,' said former investment banker Philip Augar. *'Innovative ideas will be scrutinised much more carefully to cross-check the risks they carry for their providers and the benefits they bring to customers.'*

Among the bankers, there was a belief that there would be more focus on the customer experience, and less on products. In particular, transactions would be streamlined and use of information technology increased to make products simpler to use – though this would rely on managing complex processes behind the facade seen by customers. The insurers saw greater use of online documentation and servicing, including providing customers with real-time information about the value of their savings.

Others addressed more fundamental issues – including HSBC's Stephen Green. An ordained Anglican minister, Mr Green has been outspoken on the importance of ethical behaviour in the banking industry in his latest book[5].

The job of a company is not to maximise its profits from one quarter to the next, he said, but to grow the business sustainably over the medium and longer-term period. *'That means focusing on what is sustainable in customer trust and confidence.'*

From the point of view of an investment manager, Barry Bateman of Fidelity International echoed those sentiments. He believed that fund managers could help in winning back public trust in financial services by tackling the tendency among companies, funds and investors to chase short-term profits and growth at the expense of long-term sustainability. *'Regulators can nudge the industry in the right direction by setting rules for bonuses, but we need a sea-change in the way people look at how companies are run.'*

Michael Spencer, ICAP Chief Executive, also saw problems with the quarterly reporting required of publicly listed banks, which had encouraged them to seek growth aggressively to satisfy their shareholders. *'We need to get back to a world in which bank shares are not aggressive growth stocks but are more utility-type stocks,'* he added.

Another common theme was the need for the industry to explain itself better to the wider world. *'From the point of view of some stakeholders, banking looks powerful, amorphous and self-serving,'* said Barclays Chief Executive John Varley. *'The reality is that what banks do is important to the economy and to society, but the banks need to do a better job of making that case. And to be clear, the Government didn't bail out the banking system to be nice to banks; it did it because bailing out the banking system was the precondition for rescuing the economy.'*

5 *Good Value Reflections on Money, Morality and an Uncertain World*, Stephen Green, Allen Lane, July 2009.

Government intervention and regulation

While the industry rebuilds relationships with customers, the intervention of government and tougher regulation of financial services pose more immediate challenges. All those interviewed for this exercise expected further waves of regulation in financial services – and that the government would continue to be active in the industry. But when it came to specific measures, there were some misgivings, with worries that unilateral action by the British authorities would damage the UK industry without tackling problems in the global economy.

Financial markets may have rebounded in 2009, but the banking industry was far from out of the woods yet, warned UKFI's Michael Kirkwood. There were areas in the provision and regulation of banking services in all parts of the industry where there were important lessons still to be learnt.

'The financial services industry is a global infrastructural industry that is central to economic activity around the world. It cannot be allowed to develop the excesses and therefore the threat to itself that we have seen in the recent crisis. The obvious consequence is that there will have to be a significant examination of all its activities to ensure that companies have the capital and liquidity to carry out their essential role in the financial system.'

John Varley of Barclays also expected no let-up in regulatory scrutiny after the searing experience of the financial crisis. *'The financial system was on the verge of collapse. We cannot ever allow that to happen again – governments can't take the risk of it happening again. I think governments are going to be on the shoulders of the industry for the next 30 years – and with some justification. You can quite understand why they feel they must do that.'*

There was some admiration for the international coordination organised to deal with the financial crisis through the three G20 summits which brought together leaders from both the developed world and the larger emerging markets. *'The global response to the crisis was overall pretty impressive and credible,'* said ICAP's Michael Spencer. *'It was definitely a positive watershed that made a difference to the outcome, and was a huge credit to the movers and shakers – the politicians and civil servants.'*

The BBA's Angela Knight believed Britain had played a central role in the G20 process by providing thought leadership. *'The UK has been one of the best at articulating what needed to be done in creating a regulatory framework for cross-border crisis management and in devising intervention techniques.'*

Gillian Tett of the FT detected a loss of momentum in global coordination, however. *'International efforts have achieved quite a lot, but the desire to tighten up is easing as the real economy recovers and the politicians are distracted by other issues. The banks had been on the floor, seemingly out for the count – but now they are regrouping to fight back... There's a danger that the regulators lose heart.'*

But the FSA's Lord Turner said he saw no loss of momentum: the Financial Stability Board was working on several programmes commissioned by the G20, due to be completed by October 2010. *'The determination is there, though there's still a lot to do – grinding out the details and then agreeing on how the new rules will actually be implemented.'*

Many of those in the industry – particularly the global operators – saw the continuation of international coordination as essential to ensure that there was a level playing field in regulation. *'We all know that if we don't have a level playing field, there will be regulatory arbitrage and activities will simply move to less regulated jurisdictions,'* said HSBC's Stephen Green.

Lord Turner acknowledged the importance of a level playing field, but noted that there was no global law-making power to ensure that international decisions were fully implemented. *'Ultimately it's up to individual jurisdictions – there's no policing*

Building societies

Two regulatory issues of specific interest to building societies were troubling Nationwide's Graham Beale.

The first was how mutuals could strengthen their balance sheets in ways that would meet the regulators' demands for some form of loss-absorbing capital. At the moment there were no financial instruments fitting that criterion which investors would be comfortable about investing in unless they had higher returns and more control.

'This raises a philosophical debate about whether it would compromise the mutual model. At the moment, we are very clear that we focus on the customers, optimising profits rather than maximising them and giving value back through pricing. That is unattractive to equity investors.'

The second issue was the funding of the Financial Services Compensation Scheme (FSCS). The cost for institutions reflected the amount of retail deposits they held, and since building societies relied more on retail deposits than others, they had borne the brunt of the failures so far – particularly Bradford & Bingley and the Icelandic banks.

'We have provisions of £258m sitting on the balance sheet, which is an enormous figure for the failure of a business model which was far more aggressive than ours. That is a much higher proportion of our profitability than is held by listed entities – and for some societies, provision for the FSCS makes the difference between a trading profit and a loss.'

The Scheme itself meant that savers were now less worried about the risk profiles of different savings institutions, Mr Beale said. In surveys of which institutions savers trusted with their money, building societies usually came out on top as solid and stable, if a little boring. But people no longer felt they had to exercise judgement because ultimately they could rely on the FSCS.

'It has introduced a moral hazard issue, because whether you are with a prudent institution or a more aggressive one, you enjoy the same protection. We feel the FSCS should discriminate more, and aggressive players should pay a higher proportion of the cost of the Scheme.'

mechanism like the World Trade Organisation which can enforce international trade law. We're trying to create that, but at the moment it's more like a club which sets rules that everyone agrees to abide by.'

Most of those interviewed said it was still too soon to see how the new global regulatory regime would pan out. *'We've only just had the starting whistle on a match that will go on for years,'* said Gillian Tett, adding that it was not until 1933 that the Glass-Steagall banking reforms were passed in the US – four years after the Wall Street Crash. *'Until we hear the final whistle, the result will be unknown.'*

On specific regulatory reforms, the need to develop the details of a new regime for capital adequacy was top priority for many of those in the industry. While balance sheets had been strengthened, much more needed to be done to set risk-adjusted capital levels for particular activities – seen by some as more effective in reducing risk-taking than action on bonuses.

However, there were also concerns about imposing requirements that were so stringent that banking activity was hobbled. *'Requiring banks to have capital for every emergency is bound to make lending more difficult and more expensive,'* said Sir Andrew Likierman, Dean of the London Business School and a Non-Executive Director of Barclays. *'The banks will then be blamed for not lending enough.'*

Michael Spencer of ICAP was enthusiastic about moves towards more central clearing of derivatives. It would be a sensible way to reduce risk in the over-the-counter (OTC) markets, he said, though it was not appropriate in all cases – genuine hedging by corporates, for example. *'Some parts of the OTC market are not sufficiently liquid and not appropriate for central clearing. Where it is not appropriate, there are other methods of reducing risk in terms of reporting all trades to a central repository so the information on the exposure of financial institutions would be available.'*

There was considerable concern about European Union proposals to regulate the alternative investment fund management sectors such as hedge funds and private equity. Simon Walker, Chief Executive of the BVCA, which represents the private equity sector, said his members had become the *'fall guys for capitalism'*, even though private equity posed no systemic risk.

Peter Clarke of Man Group, the world's largest listed hedge fund group, said it was noticeable that investors had joined the sector in lobbying against some of the changes. *'Most sophisticated investors want to be free to invest in the risk propositions they choose.'*

Sir Andrew Likierman was concerned that the UK authorities would respond to pressures from continental Europe. *'The Germans and the French are cheering on those who want greater regulation of banks, because they stand to gain from that. I am very concerned that the British are regulating* *their own banks in a way that could well put the City at a disadvantage.'*

The Dean of the London Business School was also puzzled by the underlying assumptions behind the remarks made by Lord Turner on the *'social utility'* of many financial services. Jonathan Moulds of Bank of America Merrill Lynch said that while he understood the concern about the social utility of some financial services, a lot of the activities criticised in proprietary trading originated from customer activity. *'It's a very simplistic characterisation that is not necessarily helpful.'*

John Varley of Barclays said Lord Turner's comments had taken people outside the UK by surprise. *'They did not understand it when the Chairman of the regulator said that much of what the banks did was useless.'*

However former investment banker Philip Augar defended Lord Turner for raising an important issue: markets awash with liquidity had come to regard trading as a good thing in itself – irrespective of its usefulness. And the FSA Chairman was unrepentant in his interview: *'Most thoughtful people know that the more exotic world of trading was not making the world a better place. If we get the capital requirements right, much of that could become unattractive.'*

The most contentious issue on regulation in the interviews was the raging debate over whether there was a need to separate retail banking from investment bank operations, often described by their critics as 'casino banking'. Philip Augar, whose recent book was subtitled *How Reckless Growth and Unchecked Ambition Ruined the City's Golden Decade*,[6] argued that it would be good to return to what he called *'Captain Mainwaring banking'* – the narrow banks of the past that collected in cash from one set of customers and lent it out to others. *'Opponents argue that this would mean products would cost more, capital would become more expensive and global liquidity would shrink. On balance I say that would be fine: we got to a position where there was just too much liquidity in the world, and it sloshed over into speculative activity for the benefit of market players.'*

Unsurprisingly, most of those in the financial services industry disagreed. ICAP's Michael Spencer thought that splitting the banks would not head off future crises – because the combination was not a cause of the failure of banks over the last few years. *'None of the four banks brought down in the UK were brought down by classic casino banking – huge proprietary trading or speculation on the global financial markets. They were bankrupted by appalling lending policies, vainglorious acquisitions, shocking funding models and 125 per cent mortgages.'*

The LBS's Sir Andrew Likierman said casino banking made a good headline, but was a red

6 *Chasing Alpha*, Philip Augar, Bodley Head, April 2009.

herring. *'Some small banks got into trouble and many large banks did not; some narrow banks got into trouble and many universal banks did not. Indeed the fact that some building societies got into trouble is revealing: it's not a complicated business model and they weren't casino banks.'*

Sir Andrew was also worried that there was a danger that the reaction to the crisis would do long-term damage to the financial services industry, while failing to prevent the next crisis. *'Over the past 250 years, there have been many financial crises, none of them exactly the same as any other crisis. The current crisis is not the same as the crises of 2003, 1998, 1987, 1976, 1967, 1949 or even 1929. There are lessons to be learnt but we cannot assume that the next crisis will be the same as this one.*

'It's like the Maginot line, built by the French to avoid a repetition of the German invasion in 1914. In the Second World War, the Germans nipped round it through Belgium and that was the end of that. There's no point in building the equivalent of the Maginot line for the next crisis.'

UK competitiveness and London as a leading financial centre

When queues formed outside branches of Northern Rock in September 2007, it was the first bank-run in the UK since the collapse of Overend & Gurney in 1866. The images went round the world, rocking London's reputation as a financial centre and evoking some *schadenfreude* from potential rivals. So how has the financial crisis affected London's position as a leading financial centre, and will the UK retain its competitive advantage in financial services?

On the former, there was almost total unanimity among the interviewees. Shocking though Northern Rock's collapse had been, it had not seriously dented London's reputation. *'London has been damaged by the crisis, but so have most other centres,'* said the FT's Gillian Tett. *'It will carry on being an important centre, though not number one as it was a few years ago. There has been a resurgence in New York's position, which would grow if the UK imposed much tighter regulations.'*

There were more serious threats to London's pre-eminence, according to many of those interviewed – including excessive or inappropriate regulation that could weaken the UK's competitive advantage in financial services. As ICAP's Michael Spencer put it: *'What is potentially damaging to London is if the regulatory burden becomes too burdensome. If there is temptation to push more aggressively on deferment of bonuses or capital requirements, that could make the UK less competitive.'*

Lord Levene of Lloyd's was concerned about what he described as *'politically motivated changes to the tax system',* which were already posing a danger to the City's leadership in financial services before the latest changes. Speaking before the imposition of the one-off tax on bank bonus pools in the December 2009 Pre-Budget Report, he listed the 50 per cent top rate of income tax, the non-dom charge on people from outside the UK and a corporation tax rate that was increasingly undercut by the UK's competitors.

'Any one of these tax measures in isolation one could almost shrug off. But when you put the whole lot together, it's bad news... People say 'Why should I work here?'

'They won't all go to Bermuda, but they can certainly go to Switzerland, and they can also go to Ireland where the corporation tax rate is 12 per cent – it's not very far off and it's not very foreign.'

Fidelity's Barry Bateman was particularly exercised about the new 50 per cent income tax rate, especially when combined with the increased National Insurance rate. *'People can see that the government is now taking more than half of any extra income they earn. We've seen a number of our people asking can they work in other countries – and of course they could.'*

'Financial services companies and the people who work in them are very mobile – and I worry that Britain is going from being pretty competitive on a global scale to being pretty uncompetitive.'

Investment managers

There was considerable disquiet among those in the investment management business over the European Union's Alternative Investment Fund Managers Directive which is due to come into force in 2012. Critics believe it will reduce choice for investors and deter investors from overseas.

Simon Walker, BVCA Chief Executive, said it could cut off the flow of private equity investment from outside the EU – the source of more than half the private equity capital in the UK.

'The most disturbing issue about the European regulatory framework is that hardly anyone involved in the European Parliament or in the Commission understands what private equity does. Officials often harbour serious prejudices that the sector is made up of asset-stripping capitalists.

'Private equity poses no systemic risk, and hasn't asked for a penny from governments anywhere. Our remuneration system, in fact, is one that promotes longer term stability by aligning reward with performance.'

Man Group's Peter Clarke saw the Directive as closet protectionism, and made a similar point to the BVCA's: 'There is no moral hazard here: taxpayers have not had to pay a penny to bail out hedge funds. There is no evidence that the sector poses any systemic risk.

'Regulators need to draw the distinction between the proprietary trading activities of banks – where traders take risk on behalf of a bank that should be a lower-risk business – and investment managers who take on risk as part of a mandate from an investor who expects a return.'

Others less directly affected by the new Directive saw base motives behind it, with the proponents trying to erode London's competitiveness as a centre for hedge funds and private equity. *'None of the financial crisis was caused by hedge funds or private equity,'* said Barry Bateman of Fidelity International. *'It's just about vote-winning, which I find alarming.'*

Mr Clarke said he would like to make it easier to invest in hedge funds, in particular for retail investors. *'Over the last decade, the private investor has been too exposed to equities, which have lost 50 per cent of their value twice in that time. The regulator should facilitate better diversification for the private investor – hedge funds should be for everyone.*

'Hedge funds are seen as high risk, but there is almost no strategy with a higher risk than equities long only.'

The consequences of the 50 per cent tax rate would depend on whether it was just a short-term measure, said Jonathan Moulds of Bank of America Merrill Lynch (interviewed before the announcement of the proposal to tax bankers' bonus pools). *'At this level, it can be tolerated for a period, but while there's uncertainty about how long it will be retained, it's difficult to attract additional capital.'*

For the BVCA's Simon Walker, the damage went beyond the impact of higher taxes: the tax regime now had a reputation for uncertainty that did not inspire long-term confidence in the UK as a place for financial services businesses. *'The taxation of bankers' bonuses sent a message that the Chancellor would play fast and loose with the regulatory environment. Stability is absolutely vital – and it takes a long time to restore confidence in stability.'*

Angela Knight of the BBA said the tax on bankers' bonus pools must be a one-off if it were not to be seen as the thin end of the wedge by the international companies operating in the UK. *'There is a lot of talk about institutions leaving, but the real questions are which will decide not to come and where will those already here choose to place their next investment.'*

Despite such worries, most of those interviewed believed that London would remain an important financial centre, because it still retained fundamental competitive advantages such as the English language, its time-zone between the Americas and Asia, its respected legal system and the supporting infrastructure of professional services and systems. *'I don't believe London's critical mass has been seriously undermined by recent events,'* said HSBC's Stephen Green.

Nonetheless, Mr Green was among several who predicted that London – along with New York and other established financial centres – would be challenged by rising centres in Asia such as Singapore, Hong Kong and Shanghai. *'This is not because of the financial crisis, but because of the shifts in the global economy. London will lose market share, though it won't diminish in importance.'*

Stuart Fraser from the City of London Corporation said the UK capital remained a hugely attractive city for financial institutions, offering a lifestyle that only New York could match. But on the threat of higher taxes, he added: *'The only people who pay the taxes here are those who love being here or who can't move. Those that can move will move. The question is where the tipping point is.*

'London's strengths are fantastic. It's a fantastic place to be and most people love it – and that's why we have this cluster of businesses and talent. But you can't constantly bash it and tax it and expect it to stay that way.'

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