

The City's reputation and reality post Brexit

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The title of this paper brings together two issues each of which is hugely significant in its own right: the City's reputation and how this relates to the reality, and the impact of Brexit. Of course, they are related. The City's reputation and reality will have an influence on the Brexit negotiations. The British government has to decide what weight it wishes to place on London's role as an international financial centre in relation to the other priorities for the Brexit negotiations. And the other 27 members of the European Union will have a view on how much they value London as a financial centre that serves them. Longer term, London's role as an international financial centre will be heavily influenced by the new relationship that the United Kingdom will have with the European Union.

This paper discusses these issues and suggests some broad principles that should be followed by the British government and within the City of London for seeking to secure London's role as a global City and the leading international financial centre, which bring substantial benefits to the whole of the United Kingdom.

Why London has achieved its present status

There is a consensus on the factors that are necessary for business generally to thrive. They include the ready availability of staff with the necessary skills, a strong legal system, a regulatory environment that facilitates rather than frustrates business, an open economy with good connectivity and the accessibility of capital. These conditions cannot be created overnight, and are not dependent simply on laws being

passed. Rather, they develop over a period of many years, although they are capable of being destroyed rather more quickly.

London has become the world's leading International business and financial centre partly because all of the factors listed above exist, and in some cases have existed for centuries. But these factors are not nearly sufficient to explain London's status. There are a number of key factors that have made London what it is.

London is not only by far the largest city in the United Kingdom but it is also the capital city and the major centre for the service industries. And it is truly a global city where nationality means little and ability means everything. The co-location of political power, capital, education and business is a powerful mix. This is the position in some other countries such as France, where Paris dominates, but it is not universal. In the United States Washington is the centre of government but little else. In Germany, Berlin is the capital city but it is not the centre of business, with finance being concentrated in Frankfurt, and other major cities also rivalling Berlin in terms of economic footprint. While the centre of finance in China is Shanghai, political power is in Beijing. Both Canada and Australia have capital cities that in themselves are quite small and which have no finance industry to talk of. At one level, this might all seem to be a relatively minor point, but in practice the synergies that result from having the centre of government very close to the centre of finance and the centre of business generally bring huge advantages. City states, such as Singapore, Dubai and to some extent Hong Kong, also show how it is possible to develop major international financial centres where government and the finance industry are close together, even in the absence of a large nation state.

That English is the international language of business is another factor that contributes to London's position as a global financial centre. Arguably, this advantage is diminishing as English becomes a universal language in many

other financial centres including those where English is not the first language.

The education system is an important factor. London has a disproportionate number of world-class universities able to attract the best students and the best faculty from around the world. The high quality of education in the Independent school sector has also helped to make London attractive to international business people. More recently, the outstanding performance of the state education sector, where London has gone from near bottom of the league table in the UK to the top of it, also adds to London's attractiveness.

One factor that cannot be overestimated in its contribution to making London what it is today is the English legal system, and I mean the whole of the system - from contract law which has evolved over the centuries and which is used in contracts that otherwise have nothing to do with England or the United Kingdom, through to the professionalism of the legal profession and the independence and quality of the judiciary. While there are legitimate complaints about the time that the legal system can take to deal with cases, Britain is well ahead many other countries in any international league table in this respect.

London has benefited from policy decisions made in the United Kingdom, even if these have not been specifically aimed at enhancing London as the centre for international business. The personal and corporate tax systems in the UK may not be the most attractive in the world, but they compare well with the systems in other major industrial countries. The regulation of financial institutions is certainly intrusive and costly, some would argue too much so, but again it stacks up fairly well compared with the position in other countries, and in exchange for the cost provides a predictable framework for business and a barrier to entry.

London and the UK generally have a regulatory regime in respect of employment and other matters that count as one of

the best in the world. While it is fashionable to talk about red tape and the regulatory burden, often wrongly attributed to the European Union, any international study of ease of doing business puts Britain near the top of the league table.

Employment law is particularly important to international businesses. Business today is flexible and needs to be adaptable, and this requires employment practices that are also flexible and adaptable. The ‘job for life’ mentality, which arguably was never appropriate, is certainly not appropriate today.

The UK has also benefited from poor decisions taken in other jurisdictions. America is by far the largest capitalist society, but it has complex, indeed byzantine, regulatory structures, with licences being required for activities that are unregulated in most countries and with financial regulation still largely being done at the state level. Some American regulation has driven business that could be expected to take place in the United States to other countries, particularly the UK. Within the European Union, rigid employment laws in Germany, France and Italy make those jurisdictions less attractive to international financial institutions and indeed other businesses.

The City’s reputation

So, having set out the background, what is the reputation of the City and how has it changed since the financial crisis nearly ten years ago? The ultimate test of this is not the views of commentators or public opinion polls, but rather whether people and businesses want to do business in the City. And clearly they do. London is the world’s leading international financial centre, attracting business and talent from all over the world. As in other areas being the world leader itself helps to retain that position. The “cluster” effect is apparent in financial services as it is in respect of culture, restaurants, creative industries, technology, education and sport.

But, there is no doubt that the reputation of the City has been damaged by a succession of financial scandals and the

financial crisis of 2007/08. Much has been written on these issues and I have no wish to do anything more than to summarise the consensus. A crisis of that size cannot be created by one factor alone. A combination of factors was responsible, including a lax monetary policy, poor regulation and supervision, bad management and a long-established culture that tolerated unethical practices combined with incentive structures that encouraged them.

Arguably, the same problems can be found in other areas as diverse as car servicing, estate agency, the health service and pharmaceuticals. But this is no defence. The wider economic effects of the crisis, combined with by any standards excessive remuneration, inevitably leads to a much greater focus on financial services than on other areas.

However, the situation has improved markedly over the last few years. Banks in particular are much safer, with higher capital and liquidity and more professional management. The worst conduct of business practices have largely been eliminated, although the fallout in terms of court cases and fines continues and will do so for some time. The quality of regulation and supervision has improved markedly, facilitated by international co-operation on a scale previously thought impossible to achieve.

However, stronger regulation comes at a price. The cost of financial services has risen, opening a bank account has become a complex issue, so much so for some as to be impossible, and correspondent banking has been sharply reduced to the detriment of developing countries in particular.

It is probably the case that the wider costs of additional regulation have not adequately been taken into account in the policy making process.

It is also fair to note that there is a disparity between the public perception of banking or insurance as activities and people's perception of their own banks and insurance companies, which is more favourable. This is mirrored in

other areas. As *The Economist* perceptively observed the British public don't like immigration but they quite like immigrants. And the Ipsos Mori Veracity Index for 2015 found that 65% of the population trust newsreaders but only 25% trust journalists, who write what the newsreaders read. There is also ambivalence on the part of the government. It certainly likes the tax raised as a result of financial service activities and it recognises the contribution that the finance industry makes to employment and prosperity generally. But there are no votes in being perceived as being nice to bankers.

Brexit

And so on to Brexit - surely the biggest self-inflicted event that a British government has had to cope with for decades. Almost anything one says about Brexit can be deemed to be politically motivated and, as in war, truth seems to have been an early casualty of the Brexit debate. But I will begin with two solid facts –

- Brexit will be very complex, particularly in legislative terms.
- The long term outcome could vary from moderately favourable to highly damaging, depending on the outcome of the Brexit negotiations and the way the government chooses to use the new freedoms that it will have.

And perhaps I can add a third fact. Membership of the EU has been good for the financial services sector, and therefore for the country. The single market for financial services, incomplete as it is, and free movement of labour within the EU, have undoubtedly contributed to London's growth as a financial centre. It has become the financial centre for the whole of Europe, serving government, corporates and individuals throughout the European Union and further afield.

This has led to more jobs in Britain and a substantial tax contribution.

Some still do not seem to understand the relevance of the single market to London's position, arguing for example that London's huge assets as a financial centre will mean that business will still be done from there, and who wants to live in Frankfurt anyway? This is to miss the point. If Britain does not retain access to the single market it will not be

possible in law to continue doing some business that is currently done from London. Passporting is a simple concept but seemingly one that is beyond the grasp of some. A bank authorised and regulated in the UK can do business throughout the whole of the EU without the need for authorisation in the other member states. The American investment banks do business in the EU not from New York but rather from businesses authorised, capitalised and managed in London. If they could not continue to do so then they would have to shift some – I stress some – business to the EU 27. It is also the case that London's attractions, including being in the EU single market, have meant that over the years business that could have been done in London or New York or Hong Kong has been done in London. Britain being outside the EU would reduce the relative attractiveness of London and over time would likely lead to a shift of some business back to New York. There is now a general consensus that the financial centre that would gain most from Britain leaving the EU would be New York rather than Frankfurt or Paris.

It does not follow that Brexit will mean a reversal. If Britain can negotiate continued access to the single market for financial services together with maintaining a say in legislation and regulation, through an enhanced equivalence or modified passporting regime, and financial institutions can continue to employ talent from throughout the EU with just a modest increase in bureaucracy, then little will change for the worse and there may be opportunities to pursue policies that could make London even stronger as a financial centre. By contrast, if Britain leaves the EU in April 2019 with no deal thus falling back on WTO rules or with a deal that leaves Britain outside the single market for financial services with no more mitigation than a two year transition then the effect could be significantly adverse.

The consultants Oliver Wyman crunched the numbers in a report for TheCityUK. The best case scenario – where negotiations secure in practice trading rights with the EU

similar to those which the UK currently has – would likely see an annual decline of £2 billion in revenues, £0.5 billion in tax revenue and 4,000 jobs. By contrast, under conditions where the UK moves to a third country arrangement with the EU, without any regulatory equivalence, and its relationship with the EU is defined by terms set out under the World Trade Organisation, up to 50% of EU-related activity (£20bn in revenue) and an estimated 35,000 jobs could be at risk, along with £5bn of tax revenues a year. However, there would also be a knock-on impact on the ecosystem, which could result in the loss from the UK of activities that operate alongside those parts of the business that leave, the shifting of entire business units, or the closure of lines of business due to increased costs. An estimated further £14-18 billion of revenue, 34-40,000 jobs and around £5 billion in tax revenue a year might be at risk.

So in broad terms a worst case scenario is 20 times worse than a best case scenario. And so another fact. The type of Brexit is more important than Brexit itself.

So what are the prospects of a good deal for the City. We will know more tomorrow when the Prime Minister makes a long awaited speech on Brexit strategy, and we will have more certainty when Britain serves the Article 50 notice by the end of March. The first issue is the extent to which the government prioritises finance. The issues are more complex and potentially serious for other sectors, particularly agriculture and food, at least in respect of membership of the customs union, and there is little political attractiveness in seeking to “protect the City”. On the other hand, the government will be very conscious of the implications for tax revenue and employment if the City loses business. It also remains to be seen whether the government will be seeking a general solution – one that seeks for example a transition period for the whole economy or even a longer-term position that would maintain access to the single market, or rather the attempt will be to protect particular sectors. The latter is likely to prove difficult, not least because there are no hard

and fast dividing lines between sectors.

Business is generally agreed on the need for an implementation period – as there is with no legislation and trade deal generally. That is, after Britain formally leaves the EU there should be a period before the new arrangements come into effect. This would give time for businesses to adapt. In the case of manufacturing this will mean some adjustments to supply chains; for services it will mean relocation of some activities. Not to have a transition period would be severely disruptive to business and therefore to people throughout the EU. And the harder the Brexit the longer the transition period needs to be.

There is then the question of the attitude of the EU 27. There is some wishful thinking in Britain on this – along the lines of “they export more to us than we do to them, they will see sense and do a good deal”. But Britain accounts for a much smaller proportion of EU exports than the EU does of British exports, and more importantly Britain has consistently failed to recognise the political importance that the EU countries place of the EU project. It has been a British failure for over 40 years to understand that for most countries the EU is not a trade agreement but a political project that has brought peace and prosperity to mainland Europe, and they will not abandon that easily if at all. So far the EU 27 have been united – no negotiations before the Article 50 notice is served and the sanctity of the four freedoms. Of course, there will be some negotiation and some give and take. Britain does need to try to influence the EU 27, but so far the noise drifting across the Channel has not been helpful – more hawkish than diplomatic.

Business, including the City, has been seeking to influence attitudes in the EU27. From the City’s perspective it is the financial centre for Europe. EU corporates understand this and do not want to see the services they currently enjoy being diminished. But it is a big step from this to assume that the impact will be so great that they will enter the political fray. The evidence so far is that EU 27 governments do not wish to be influenced by their corporates and consequently the

corporates are tending to stay out of the debate.

City institutions will follow the political debates over the next few years with great interest. But their priority will be to ensure continuity of service to their customers and safeguarding their return on capital invested. They cannot assume a good outcome of the negotiations, but rather must work on a worst case scenario; to do otherwise would be reckless. And the worst case scenario is that on 1 April 2019 Britain will not have access to the single market and that there will be curbs on the free movement of labour between Britain and the EU. Some businesses will be seeking short term solutions – such as building up a modest business elsewhere in the EU and keeping as much activity as possible in the UK, for example through back-to-back arrangements. Regulators in other EU countries may well be sympathetic to this sort of approach – not least because they do not want the risks that would go with large scale transfers of business. So any implications for employment in the short term may be quite small. But, once the relationship between Britain and the EU becomes clear – and this could well take five years from now, longer term location decisions will be taken. Similarly, in five years' time regulators may well have a different view than they do now of the activity that they will require to be located in their jurisdictions in exchange for allowing an organisation to be authorised there.

Britain's relationship with the EU will be a key factor in those decisions, but there will be other factors – and that is where the talk of opportunities arising from leaving the EU must be turned into reality. There is no point in having freedom unless it is used. Britain will be freer to do its own trade deals – assuming it is no longer in the customs union. But this is of little relevance to financial or indeed other services as trade deals are largely concerned with goods. Of course, Britain should continue to seek the opening up of financial markets, particularly in India and China, but whether Britain stands a greater chance of success acting alone rather than as part of the EU remains to be seen. Those businesses that have persevered with the Indian and Chinese markets know just how difficult they are, and British banks and insurance companies that have operated in the US equally know that regulatory convergence sufficient to open up markets is difficult.

So the focus must not be on seeking to open up markets – although work to achieve that must continue – but rather to make the UK an attractive place to come to to do business – as Singapore has done so effectively and as other states such as Hong Kong, Dubai and even small jurisdictions like my own original home of Jersey have done. This does not mean a “race to the bottom” in terms of regulation and slashing tax rates. Nor does it mean that Britain should become an offshore financial centre – it is far too big to do that. But it does mean a very careful consideration of a whole host of policies, and that consideration must be done in the context of the likely world in 2030 not the world of 2015.

There are some fairly clear global trends that will shape economies and society generally in the next quarter century. Technological change has become more rapid and this trend is likely to accelerate. Automation is often seen a threat to jobs. And it is a threat to some jobs. But all the evidence is that automation increases employment and prosperity as low skilled jobs are replaced by high skilled jobs. Typically, new high skilled jobs pay £10,000 a year more than the low skilled jobs that they replace. It is estimated that a quarter of all jobs in the service sector are at risk of automation. The role of government is not to seek to prevent this but rather to facilitate it, and this means above everything else, having policies and practices on education and training that equip people with the skills needed for the economy of tomorrow not the economy of today.

Technological change and improved communications will continue the trend towards globalisation. While politicians in many countries will seek to promote protectionism, particularly in respect of physical goods, their efforts will be swamped by people taking decisions into their own hands. So health tourism will grow whatever politicians do to try to prevent it, and so will the internationalisation of higher education. As Britain adopts policies which have the effect of reducing the number of foreign students coming to study here, the effect is not to reduce students seeking to study abroad but rather to influence where they study – the USA and Australia have already become the beneficiaries of Britain's policies.

Longer term

Longer term, inside or outside EU, Britain's future and the City's future depends on the same set of factors but with different emphasis depending on EU relationship. There is the overriding factor of talent. The successful economies are increasingly those with the best talent. This requires a mixture of home grown talent, so outstanding schools and universities, and talent from around the world - not only because no nation has a monopoly of talent, but also because diversity is an important driver of success – and diversity does not just mean within a community.

The Government has an important role in creating the right environment in which business can thrive. There are a number of areas where this is important –

- Physical connectivity – no flights equals no business. London still scores quite well in this respect but the current handling of airport capacity is not encouraging. And London requires a better transport network and better management of the network we have. Crossrail will be great, but Crossrail 2 is essential. And while the use of private cars should continue to decline, ill-thought out proposals such as the cycle superhighways must be avoided.
- Britain is nowhere near the top of the league table in respect of electronic connectivity - we must aspire to be like the Baltic states - Latvia, Lithuania and Estonia, which have shown the way. Fortunately there are signs of improvement. The City itself is playing a role in this have just announced plans for high speed wireless connectivity throughout the City
- Tax is important – both personal and corporate. Britain already scores fairly highly in this regard, certainly compared with the major industrial countries. But it is important that public policy is on the basis that a tax is a price and the higher the price the lower the demand. The British government has arguably already gone too far in a number of areas – the bank levy and stamp duty of expensive houses, such that higher tax rates may lead to lower revenue. Tax changes need to be carefully thought through and with the assumption that they will affect activity.
- Regulation is of course crucial, particularly in respect of financial services. There is a really big issue for the British government here – on the assumption that Britain will not remain in the single market. In the short term the preference is probably to seek to mirror EU legislation so as to minimise disruption. This will entail implementing

new EU regulation even after Britain leaves the EU. But there are probably a number of minor tweaks that can be done even while maintaining equivalence with the EU, which would help to retain and attract business to London. Longer term, Britain has the choice of striving to maintain equivalence, which does not accord with “taking back control”, or developing its own regulatory philosophy and policy with the aim of getting business to come to London rather than seeking to provide services to the EU from London. Government and regulators need to be thinking about this now – but under the huge constraint that handling Brexit will be a massive call on resources. So there is scope for some industry and academic thinking on this.

- And finally there are trade deals, but overhyped in respect of services as trade deals are still predominantly about goods not services.

Guiding principles

So let me conclude with some guiding principles that I think should shape government policy and the City of London in the next decade. And I begin with a quote from Alec Ross in his book *The industries of the future*: “In the 20th century the dominant political divide was between left and right; in the 21st century it will be between open and closed political and economic models.”

To pursue an open society model will require not just politicians but a much wider range of people to engage in the political debate, because the debate will be political and not economic. To quote Edmund Burke: “The only thing necessary for the triumph of evil is for good men to do nothing.” Those who believe in liberal economy have to be willing to make the case.

In respect of the EU we seem to be heading for an exit from the single market – but this does not mean breaking all ties with the EU, and it should mean recognising the “gravity theory of trade”. In the short term there must be an appropriate transition to a new regime. A week may be a long time in politics – it is a tiny amount of time in business investment. And as I have indicated, if the UK wants to be out of the single market then a radical reappraisal of policies on tax and more particularly regulation is needed to make the UK attractive to international business.

And finally it is impossible to over-emphasise the important

of access to talent, both home grown and international.

Britain is an open economy and London is a global City.

Membership of the EU has been helpful in both respects.

Outside of the EU Britain can be an open economy and London can still be a global City and the world's leading international financial centre. But this will not just happen. It will require political and business leadership on a scale that we have not seen in this country.