

Radley & Associates

Future demand for office space in the City of London

Gaining insights from the Banking Industry

March 2004



Radley & Associates



Agenda

- Background and media stories
- Our conclusions
- Analysis of major trends
- Summary



There have been stories of gloom...

City bracing for record job cuts

*Simon Watkins, Mail on Sunday
16 March 2003*

JOB losses in the City could soar to record numbers this year after one of the stock market's most dramatic weeks of trading.

Though share prices ended up at Friday's close, the stomach-churning market moves of the previous five days left banks and brokers shell-shocked and fearful of sharper market falls and more job cuts.

About 20,000 jobs have been lost in the City since 2000 and forecasters predicted a further 15,000 would face the axe this year. But some analysts are predicting the jobs cull could rival the bloodbath of 1990 when one in five City jobs were lost. That would mean about 30,000 job losses in total.

Bank of America is expected to wield the jobs axe on Tuesday with its share trading department set to bear the brunt of cuts. The bank has said it will cut 1,000 staff in its technology and operations divisions worldwide by the spring.

Plunging volumes savage the City

Jane Padgham

THE devastating slump in the City was highlighted by a survey showing business volumes at the end of last year fell at the sharpest rate since the early-1990s recession. The poll of financial services firms by the CBI and PricewaterhouseCoopers also revealed the biggest dive in profitability since 1991 and a jobs cull in an attempt to slash costs.

London firms shed jobs

Malcolm Withers, Evening Standard

The City was preparing for another round of punitive job cuts today as US-owned investment bank Morgan Stanley announced 2,200 worldwide redundancies, with "scores" expected to go in London.

Jobs will also go at the Dutch owned ABN Amro, cutting 500 more in its worldwide corporate and investment banking division, some of which will go in London.



. . . and stories of Offshoring

CITY JOBS MAY SWITCH TO INDIA

Graeme Beaton Mail on Sunday 11 May 2003

HIGHLY paid analysts working for some of the City's biggest investment banks may have their jobs outsourced to India in the drive to cut costs. Following moves by companies such as British Airways, HSBC and Prudential, which have transferred call centres to India, major City businesses plan to follow suit. Experts claim that only the most high-profile analysts, who have to meet the companies they cover face-to-face, will escape the move to cheaper locations such as Calcutta and Bombay.

In the US, where a number of big banks including Morgan Stanley and JP Morgan have already started outsourcing analysts' work to India, it is reckoned that up to 500,000 Wall Street jobs - or 8% of America's financial industry - could shift to the subcontinent in the next five years. 'Most of these analysts have people doing the legwork and that can be done on the phone or online. In India they can find cost savings of 30 to 50%.'

And customers are often unable to tell if they are talking to someone in Delhi or Derby. Indian staff are given 'accent neutralisation' and 'cultural immersion' courses. 'Some companies get their employees to watch news programmes from the country they are serving so that they know the latest football scores and they can talk about the weather there. 'They don't necessarily mislead clients about where they are - they just don't draw attention to the fact that they are in, say, Bangalore.'

Research analysts in India take home about \$25,000 (£16,300) compared with the \$250,000 often paid by US brokers. For the moment the idea is that Indian-based analysts would carry out basic tasks such as collecting data to support senior colleagues in London and New York.



Eye catching headlines - but not the full story

- **We estimate overall employment in the City is set to grow by about 4% a year**
- **Most low paid clerical jobs have already been moved to lower cost centres in the UK and abroad**
- **Demand for highly skilled roles continues to grow**

Where cost is the primary driver, London may lose jobs but where added value is most important jobs will be created



Why does our data give such a different picture?

- **Based on trends we have observed in the industry**
- **Detailed survey of intentions as expressed by senior management**
 - Research sponsored by the Corporation of London
- **Breakdown of employment by function or type**
 - Some areas are growing faster, some are more or less susceptible to outsourcing

Major Trends and Changes



Major Factors affecting the Banking sector in London



- **Basel II and the growth of risk management**
- **Increasing regulation**
- **Geographic shifts in banking competitiveness**
- **Drive for efficiency**
- **Product innovation**
- **Competition from other centres**



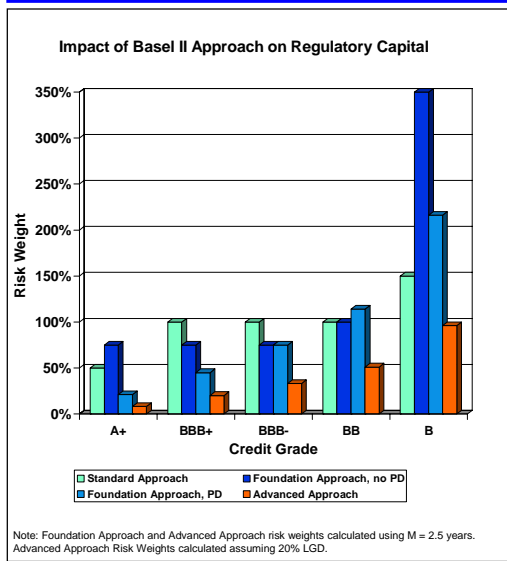
Basel II is the biggest change to banking in a generation

From	To
<ul style="list-style-type: none"> > Intuitive and based on the lender's judgement > Relationship based > Little differentiation in pricing for differing levels of risk > Simple financial analysis of deal > Originate and hold loan > Market price arbitrage 	<ul style="list-style-type: none"> > Statistically based analysis to support lender's judgement > Price based (Return on capital) > Prices based of finely differentiated levels of risk > Complex modelling as standard > Reduce risk by selling some of loans in secondary market > Risk price arbitrage

These changes will have a major impact on the number and types of people employed by banks



Banks with advanced risk management systems will hold less capital and therefore be more profitable



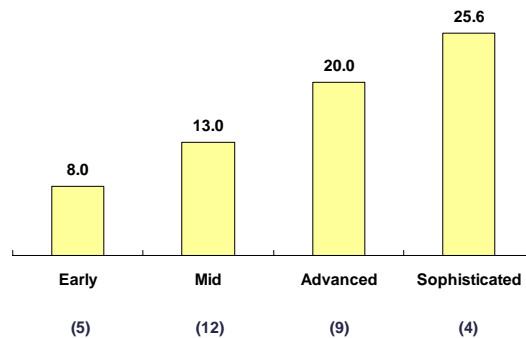
- > Risk weights are considerably lower under the Advanced Approach compared with any of the other approaches
- > By being able to hold less regulatory capital the Advanced Approach banks will either earn higher margins or compete on price
- > Non-OECD banks will find it difficult to follow the Advanced Approach.
- > Banks with smaller portfolios may decide to exit the market rather than invest in new capabilities
- > The techniques used by banks at the Advanced level should increase transparency and enable secondary trading and thus we expect an increase in securitisation and credit derivative trading based on IPRE assets
- > Pricing should more closely reflect the actual risk in a deal

Those banks that have already built the Basel II risk systems have much higher performance



Average Benchmark Return on Capital

Risk Management Sophistication



High return banks can and do grow much more rapidly.

Arguably, risk management is becoming the single most significant competitive factor shaping the banking industry

Basel II will increase City employment



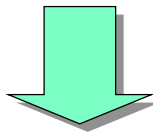
- **Banks will need more staff to comply at the advanced levels**
 - With very high levels of skill
- **Banks not complying at the advanced levels may be driven out**
 - Non-OECD banks will have more difficulty complying
 - But represent a very small share of City employment
- **Banks' portfolios may concentrate**
 - Small generalist banks concentrate on niche product areas as the cost of compliance in each asset class increases

In the medium term, these new roles will be evolving and not easily supplied from remote centres



Regulation is increasing rapidly

- High profile trading and miss-selling disasters
- More concern about money laundering
- Increasingly litigious environment
 - With the regulator as a potential target
- Increasing complexity of products traded in London



- Regulatory compliance function is growing rapidly in large banks
- Some small banks may withdraw or new entrants be put off



Despite recent setbacks⁽¹⁾ the largest sector of banks are in good shape

<u>Bank Geography</u>	<u>Characteristics</u>	<u>Future</u>
Anglo Saxon (70% by employment) <i>US, Canada, Australia, New Zealand, UK, Nordic</i>	<ul style="list-style-type: none"> ● Aim to maximise shareholder returns ● Focus on return on capital ● Use advanced risk metrics ● Will 'win' under Basel 2 	Stable growth (funded by retained earnings and access to capital markets)
Continental European/far East (22% by employment) <i>France, Germany, Spain, Italy, Netherlands, Japan</i>	<ul style="list-style-type: none"> ● Complex holding structures ● Mixed aims and objectives ● Lower returns on capital ● Less use of risk metrics 	Consolidation & reduction (balance sheet repair, less support from governments)
Emerging Markets (3% by employment) <i>South Africa, Kuwait, India</i>	<ul style="list-style-type: none"> ● London less profitable than home country ● In London for hard currency and learning 	Reduction in short term (may grow in the long term as economies expand)

(1) Stock market falls, telecoms and internet bubbles, US/European recession, war, 9/11

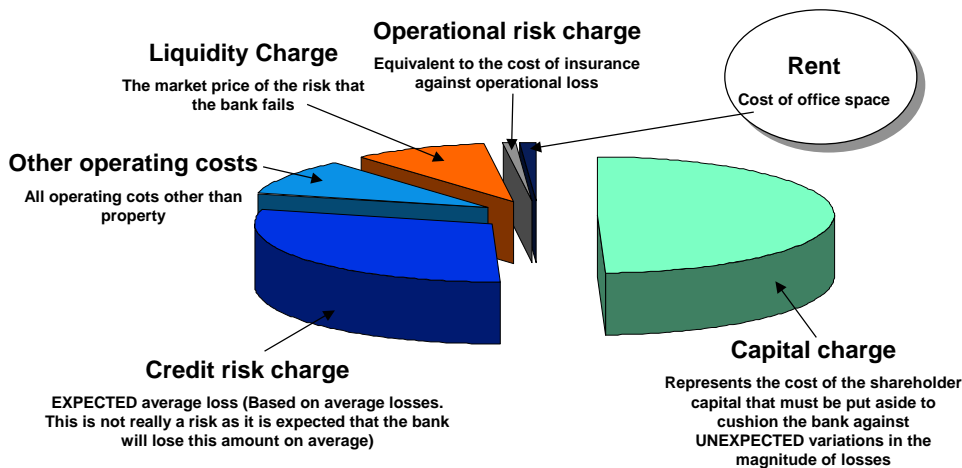
Few City based banks expect to outsource even their back office activities in any significant way



	Share of banking staff	Plans to outsource	Functional growth estimate	Net estimated growth in London	Weighted impact
Clearing & Settlements	17%	20%	Stable	-5%	-0.8%
Risk management & control	5%	7%	50% - 100%	60%	2.8%
IT	10%	13%	Modest 5% - 10%	0%	0.0%
Personnel & Training	3%	7%	Stable	-1%	0.0%
Credit scoring	4%	0%	Down 5%	-5%	-0.2%
Finance	7%	10%	10% - 20%	10%	0.7%
Compliance	1%	-3%	50% - 100%	70%	1.0%
Internal Audit	1%	0%	50% - 100%	70%	0.8%
Other support	11%	NA	NA		0.0%
Total support	58%				
Total weighted impact					4.2%

London's high value, bespoke transactions require clerical roles to be close to the front office – most high volume roles have already been outsourced.

A banker's view of the cost of lending(*)



The cost of having staff in London is not uppermost in Bankers' minds

(*) Radley & Associates estimates for corporate lending activities



London is set to continue its record of innovation

Summary of factors affecting innovation

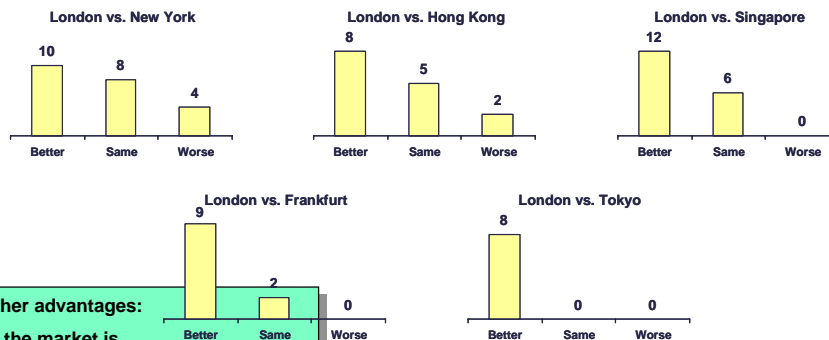
- **Innovative products continue to be the most profitable**
 - Example: Hedge fund margins vs. normal investment fund margins
- **Demand for new solutions from changing customer sectors**
 - Examples: Insurance and pensions sectors
- **Changes to capital cost structures**
 - Example: new Basel 2 framework will open new arbitrage opportunities
- **Adaptation of successful instruments from other markets and customer needs**
 - Example: Catastrophe derivatives, weather derivatives
- **Advancing methodology for risk measurement**
 - Example: Black Scholes models for options' pricing
- **Increasing computer power**
 - Example: Monte Carlo Simulation of credit risk

The continued growth of product innovation is probably the biggest single factor affecting employment in London.



London holds its own against alternative financial centres

London Performance vs. Other Financial Centres



London's other advantages:

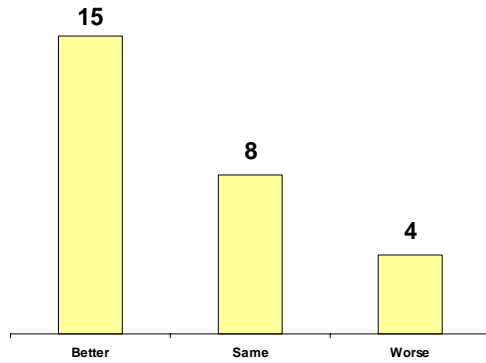
- 1 Where the market is
- 2 Record of financial innovation
- 3 Not too heavily regulated
- 4 Flexible employment law
- 5 Large pool of skills
- 6 English language and law

(1) Source: interviews with London based general managers n=31

London branches also generally perform better than their Home Country institution



London Performance Relative to Home Country



Regional Variations

- European/Japanese branches tend to perform better in London than their Home country
- North American and Australasian branches perform similarly
- Rest of World branches tend to perform less well in London than their Home Countries

Capital tends to flow to the most profitable location

Most significant trends point to increasing City employment



Trend

Effect

Impact on City employment

<u>Trend</u>	<u>Effect</u>	<u>Impact on City employment</u>
Basel 2 & growth in risk management	Demand for highly numerate staff	Large increase of highly skilled staff
Regulation	Drive out smallest players but generally increase employment	Increase in high skilled staff
Geographic factors	Gains amongst Anglo Saxon banks – losses for others	Stable growth
Efficiency/outourcing	Mostly done – not a priority for most	Small decrease in low skilled staff
Product Innovation	Continuing changes in market demands and technology	Large increase in high skilled staff
Competing centres	London remains strongest	Little loss to alternative centres