Radley &
Associates

THE OUTLOOK FOR BANKS OPERATING IN THE CITY OF LONDON

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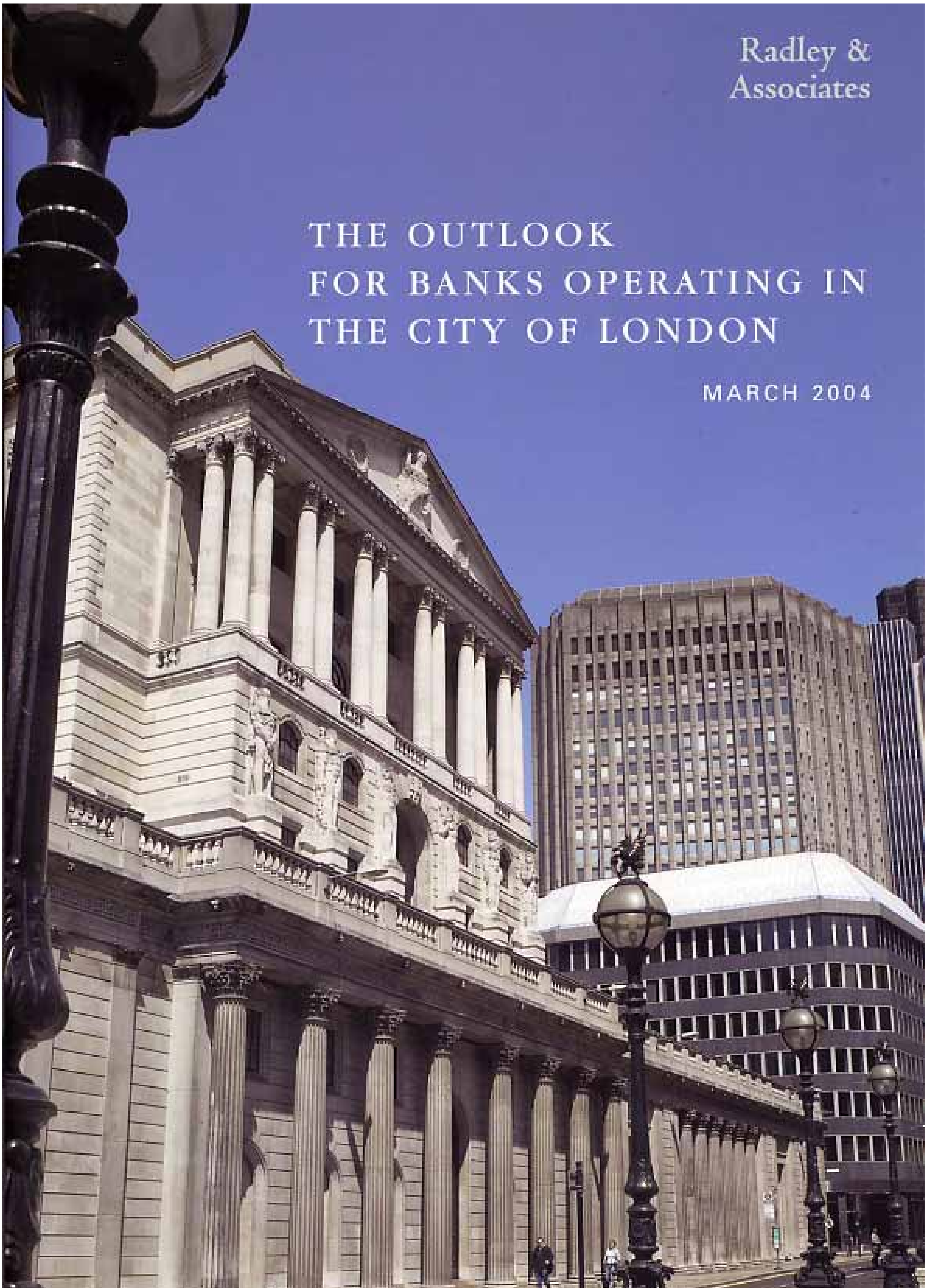


Contents

i Executive Summary

This report is based on research carried out for the Corporation of London, mostly through interviews with general managers of international commercial banking operations in London and financial data provided by the banks' own staff.

The objective of the research is to understand the main factors affecting the number of banking jobs that are located in London and, therefore, the expected demand for city office space in the medium to long term.

Background
The research finds that although there has recently been a reduction in employment levels, especially in equity trading and M&A, other areas have remained steady. Compared with Paris and Frankfurt, where there has been some strategic reduction of activity by some of the largest international banks, reduction of employment in London has been mostly cyclical in nature and few of the large employers are currently considering significantly reducing their London presence.

Conclusion
The authors conclude that the number of staff employed in London (and hence requirement for office space) is likely to continue to grow in the medium to long term. Employment is expected to shift from more low skilled to more high skilled and comprise fewer liberal arts graduates and more mathematically literate staff. Most banks expect to grow employment in the short to medium term.

Basel 2
The effect of Basel 2 will be to increase employment of risk management staff in London. Those banks unable to comply may have to curtail their activities in London as compliance with Basel 2 at a lower level will make them less competitive. To comply with Basel 2 at the advanced level, many banks may focus on fewer products, leading to a concentration of Banks' portfolios. Although efforts are required over the next three years to comply with Basel 2, the focus on quantitative risk measures is unlikely to relax subsequently and there may be a growing need for highly qualified staff with quantitative skills.

Regulation
Increasing bank regulation will require more senior staff in London's banks. Although the increasingly complex and expensive regulations reduce still further the attractiveness of London to small, emerging-market banks this factor will be more than offset by the increase in employment in the large international banks.

Geography
Average bank profitability in London varies strongly according to the country of origin of the bank. Return on capital in banks from North America, Australasia and Scandinavia exhibit a strong focus on creating shareholder value through aggressive capital management leading to the use of more innovative (and less balance sheet intensive) products and services. Comprising the largest group in London, these banks have tended to centre their European operations in London and are likely to remain and grow in London attracted by its large and flexible pool of capital and expertise.

Continental European and Far Eastern banks generally exhibit lower levels of return on capital in London. Some of these banks are facing significant reform in their home markets (though slowly in many cases) and their future in London is less certain. Although this group, on average show better returns on capital in London than they do in their home markets, they face a number of years of consolidation, reform and weak balance sheets and are likely to reduce their share of London's banking market.

Emerging market banks are the least homogenous group of banks in London. Unlike European banks, their London operations are often *less* profitable than their home markets but they may stay in London for other reasons (earning hard currency, transferring banking techniques and products back to their home market etc.) However, changes in tax treatment and the difficulties posed by Basel 2 both count against these banks and we expect some reduction over time of their presence in London.

Efficiency and Innovation

The growth of product innovation is probably the single biggest factor affecting the growth of employment in London. Although hard to quantify, it is also hard to argue that it should drop below the levels of the last two decades. Efficiency gains, by comparison, are now relatively low and not critical to cost competition and therefore unlikely to reduce back-office employment as fast as new products increase the demand for back office staff.

Attractiveness of London

London remains attractive to foreign bankers because they believe that London still:

- offers more attractive opportunities than at home
- is where the market is
- will not be affected by a Euro decision in either direction
- is a centre for financial innovation
- is not too onerously regulated.

London is still considered a better place in which to do business than the main European alternatives. It may be safe to conclude that London will not loose its attraction given the important proviso that these advantages persist.

Functional impact

Employment in Clearing and Settlements and Credit Control activities may on balance decline in the medium term with up to a fifth of banks considering outsourcing. However, these two activities represent less than 22% of bank staff in London.

Risk Management, Compliance, Finance and Internal Audit staff are set to grow significantly and IT and human resource staff may grow more steadily. The number of middle office (e.g. risk analysts) are likely to grow as will front office staff.

The authors estimate that employment will continue to grow, after cyclical adjustments, at about 4% a year.

ii Introduction

The research supporting this report was commissioned by the Corporation of London. The report is designed to provide the reader with a broad overview of the major trends in banking and how these will affect a number of factors including employment, skills requirements, office space and the general competitiveness of the London financial services market. The report analyses banks operating in London and thus the focus is on investment, corporate and commercial banking along with payments and head office functions. The research was conducted mainly in the City of London but the authors have also included banks operating in Canary Wharf and some institutions located in the 'West End'.

iii Approach

The information in this report is based on a survey of corporate and wholesale banks in London. Over thirty banks participated in the detailed survey that included interviews with senior executives and a set of benchmark data provided by the bank's finance department. Much of the opinion expressed is based on interviews conducted at General Manager level with London based banks. Further information has been used form Radley & Associates own research and other sources of information include public sources such as Euromoney, Annual Reports, Bank websites and Banking reference works.

Where we use the phrases, short-term we mean 1 to 3 years and long term we mean 3 to 10 years.

The total number of people employed in 'City-type employment in London in 2001 is approximately 245,000:

International Banking	23,000
Foreign Exchange Trading	20,000
Domestic Banking	15,000
Securities Trading (UK)	15,000
Securities Trading (International)	36,000
Derivatives	16,000
Corporate Finance	11,000
Fund Management	13,000
Insurance	29,000
Professional Services	28,000
Other Activities	39,000

Source: Lombard Street Research Estimates, Growth Prospects of City Industries, Corporation of London, September 2003

For simplicity we have sub-divided London based banks as follows in order to provide the reader with a framework with which to help understand some of the key trends. This methodology is a necessarily simplistic and thus some banks could be classified in more than one category:

- UK based ‘clearing banks’ (for example, Barclays, RBS, HBOS, HSBC, LloydsTSB): These are major universal high street banks that are engaged in a broad range of activities. They are distinguished by having large-scale distribution through branch networks. Most UK based banks have some head office functions in London along with payment centres. Additionally, these banks provide a full range of products and services to most sectors of the market from personal banking to corporate treasury services.

- Investment Banks (for example, CitiBank (SSB), Goldman Sachs, JP Morgan Chase, Deutsche, Lehman Bros.): These banks are either ‘bulge bracket’ institutions that are independent or part of global universal banks. These banks tend to earn their money via advisory fees, trading activities and lending.

- Global/regional corporate banks (for example, CitiBank, JP Morgan Chase, Bank of America, HSBC, ABN Amro, SocGen, BNPParibas): These banks provide some of the same services as the investment banks but are distinguished by having a global presence and are thus able to offer transaction and other services to global corporate clients.

- Corporate Banks (for example, Danske, Anglo Irish, Commertz, DZ): These banks are either small independent corporate banks or the London branches of large foreign banks. These banks tend to be much smaller than those above and often only offer a limited range of products to a small group of clients.

1. Main Market Trends

The past three years have been difficult for the banking industry with some significant reduction in activity across most sectors and geographies. The primary cause of these difficulties has been the general slowdown and recession across most of the world’s economies. The sectors of the banking industry that have been hardest hit have been equities and merger and acquisitions. It can be argued that the ability of banks to reduce staff when market conditions are tough has been one of London’s competitive advantages when compared to other European locations. The major investment banks have reduced staff numbers in areas such as equity trading, M&A, loan syndication and asset management.

Many non-UK banks not only reduced UK staff numbers but also repatriated non-UK staff back to head-office. While there has been a major reduction in activity in London based investment banks almost all major participants expect to revitalise their teams as soon as conditions permit. This is quite unlike the situation in other European financial centres such as Paris and Frankfurt where some of the cuts were strategic and banks have withdrawn activities back to London or New York permanently.

Other sectors of the banking industry have held up relatively well with corporate lending and other wholesale banking remaining relatively buoyant.

Most bankers are of the opinion that as conditions improve and activities in these product areas increase so too will employment pick-up. Banking is a highly cyclical business and as some product areas boom others tend to drop. Over the past ten years banks have become increasingly sophisticated in the way they manage the risks on their balance sheets. This has been particularly apparent with the limited damage done to banks by the recent recession. Since the beginning of 2004 many bankers are expressing increased confidence in most market areas and we have seen evidence that investment in both people and capabilities is reviving.

1.1 Basel II

The international Banking agreement known as Basel II is due to come into force by the end of 2007 and is expected to have a major impact on banking throughout the world. Although the implementation date is 2007 (and there is still considerable lobbying for both changes and delays), many banks are working toward compliance even now because compliance is likely to involve the use of at least 3 years of historical data, so the data needs to be collected from now onwards. Thus, while many banks are uncertain on the Basel II timetable, they consider the risk of being non-compliant far too high for them not to have programmes in place.

Although the chief objective of the Basel II agreement is to improve the stability of the banking system, the agreement will have many affects on Banks and in some cases, significantly affect their underlying competitiveness.

The main changes contemplated in the Basel II agreement affect the amounts of capital a bank will be required to set aside (in safe but low return assets such as government bonds) in order to carry out different types of business.

Operational risk

New operational risk regulations will require banks to methodically assess and report on all types of operational risk they face, be they technological (e.g. systems shutting down): fraudulent (e.g. staff diverting funds or trading beyond their limits), or managerial (e.g. lack of supervision leading to breaches of procedure and subsequent loss). According to this assessment of risk, banks will be required to set aside operational risk capital. In general, the operational risk is likely to be larger for liability products (Pensions, savings and investments) and smaller for lending products such as loans. In employment terms, the requirement is for most banks to set-up operational risk departments to assess risks, record them and in many cases establish risk databases, to record all actual or close events and the costs of remedying them. In a typical London branch of a foreign bank, this team may be as small as two and for a larger bank 4 or 5 with implications for more IT effort. Over the City, this may result in about 1,000 extra staff in 350 banks.

Large Banks and ‘utilities’ involved in transaction type businesses such as payments, cheque clearing and securities will face a much larger task and in the short term will have to engage expert resources to design and implement new systems. This will involve both the use of internal staff and external consultants. It should, however, be noted that many of these large scale processing centres have already moved out of Central London to areas where both staff and space are cheaper – we therefore expect this to have a limited impact on future employment trends.

Credit risk

More significant is the proposed change in Basel II on the risk capital required for lending products such as Mortgages, Retail loans, Credit Cards, Corporate lending, Project Finance, Real Estate lending, Leasing, PFI financing and Trade Finance.

Most of the major UK based retail or ‘clearing’ banks and mortgage lenders have moved their personal banking operations out of Central London so we do not envisage a major impact on the City of London from the proposed Basel II rules in this area.

Commercial and corporate lending along with treasury operations, account for the majority of the credit activities of London based banks. The chief change envisaged by Basel II is a new way of calculating the credit risk capital required to underwrite each type of lending.

Depending on the accuracy with which each bank can measure the risk associated with each of its loans, the London regulators (or EU regulators of ‘passported’ banks), working within the new Basel II framework, will determine how much risk capital must be put aside. The banks with the most accurate risk measurements systems will be classified as compliant with the Basel Accords at the Internal Based Ratings (IRB) Advanced Level and will be required to set aside low levels of capital, whilst those less able to measure their risks will be classified as compliant at the Standard level and will be required, effectively, to set aside more capital than those on the Advanced Levels. The net effect of this categorisation is that less sophisticated banks (as measured by their ability to measure risk) will have to hold more capital than banks, judged by the regulators to be more advanced, for the same piece of business. Since risk capital accounts for some 75% (Radley & Associates estimate) of corporate and commercial banking costs, this will act as a major competitive disadvantage to those classified at a lower level of Basel II compliance in London’s price sensitive banking markets. The variation in capital levels required can be of the order of 50%, thus leaving ‘Advanced’ banks at a potentially 40% cost advantage when measured in terms of return on capital.

Not surprisingly, almost all the OECD based banks interviewed are aiming at Basel II compliance at the Advanced Level. However, there are some significant difficulties in achieving this level of compliance. Advanced compliance requires a solid, statistical record of loan defaults for each type of customer and loan to calculate the probability of default (PD) and the amounts lost in each case to calculate the loss given default (LGD) in each case. Many OECD economies have strong, economy-wide and pooled data from which these calculations can be made, but developing economies often do not, thus making compliance harder or at least making it take longer.

To enable compliance at the Advanced Level across a typical commercial banking portfolio requires amongst other things:

- Easily accessible records of all loans and loan defaults going back at least one economic cycle.
- Control of the credit process.

- An ability to calculate, measure and record the capital required for each loan at each point in time of the loan

- Ability to use computer simulations (such as Monte Carlo analysis) where data is insufficient (in some product areas this is always the case).

- A culture that uses return on capital measures to make banking decisions rather than a profit and loss view.

- An understanding (and measures) of how lending decisions affect shareholder value creation.

- Flexible and integrated IT systems.

- Statisticians capable of developing these tools – and more importantly – explaining them to line and senior management.

- Ability to implement these new systems with the existing banking systems.

The long list of requirements will have a significant impact on the direction and volume of recruitment in London in the next decade. The types of skills required will boost so-called middle office numbers whilst not necessarily reducing the front or back office contingents. New recruits are likely to be working in the rapidly expanding Risk Management departments, and swelling the ranks of the Finance and IT functions. For an average bank to comply with Basel II is likely to involve at least 5 new staff for a small bank and more like 10 – 50 for a large one. The IT requirements alone are likely to match those needed for the Y2K or Euro conversion work and they are less likely to dispel, once the initial urge to comply has been met. Indeed, it is likely that once banks adopt more rigorous risk metrics and methodologies they will continue to enhance and develop these capabilities over the long term.

Risk management departments, who will generally dictate the level of capital required for each loan and therefore its profitability, will by necessity become more prominent possibly at the 'expense' of the front office lenders and relationship managers. Lending decisions will be made increasingly on analysis of data and statistics generated by 'mathematically literate technicians' and less on the judgement of traditional, arts educated, lending officers. This culture shift is driven by the simple calculation of return on capital: since the market more or less determines the price or margin of a particular type of deal and Risk management will determine the capital required to do the deal, the front office lenders have a reduced role in influencing the profitability of a transaction.

The effect of Basel II in London is three-fold:

1 Banks will need more staff to comply:

Evidence clearly suggests that banks will require more risk management staff. UK based banks and Investment Banks are likely to host these roles in London, requiring as they do, highly qualified, hard to find staff who will need frequent access to senior management. As such, outsourcing risk management (despite the wealth of highly numerate job seekers in non-OECD countries) is unlikely to happen in the short term.

Much of the risk management work for non-UK based banks will be carried out in the head offices of banks, limiting its employment impact in London. However, there will be roles for Basel II implementation and maintenance in London, even though the planning is carried out in head office. For small banks with 30 – 60 staff in London, the cost of Basel II compliance – at any level – is yet more cost for an operation that may already be sub-scale. It may, in some cases result in withdrawal. A potential threat to London may emerge as the demand for high-grade mathematicians increases and the UK is unable to provide them in sufficient numbers. These jobs will have to be sourced locally, or staff will be imported or the work will move to where the skills exist.

2 Banks not complying at the Advanced Level may be driven out:

In the long run the competitive shakeout of smaller and less focussed banks is likely to be more significant than short term staffing up for compliance. Banks originating in the UK and other OECD countries, whose primary business is local retail banking, may decide not to develop Advanced Level risk systems for their London based corporate operations as the cost will be very high and it will confer little advantage to their core businesses. These London based units will therefore be disadvantaged in comparison to those corporate/commercial banks that have implemented Advanced Level systems. These banking operations may be operating at such a disadvantage that withdrawal from London is the most rational option. Non-OECD banks, who for structural reasons are unable to comply at the Advanced Level, may also decide that the odds are stacked too much against them in international markets and retrench. It seems unlikely that, over the long run, any bank will be able to compete in the commercial lending markets in London if they are not complying at the Advanced Level. All other things being equal, this should reduce the number of smaller and non-OECD banks in London (foreign banks engaging the vast bulk of employees by number).

3 Bank's portfolios may concentrate:

Many of the banks in London offer a fairly broad product offering. For example, many small banks focus on cross-selling to existing customers (getting a greater share of customer wallet) which has resulted in Bank's with fewer than 30 front office staff offering FX, Money Market, Trade finance, Lending, Leasing and Project Finance products. The cost in terms of management and IT effort of complying with Basel II at the Advanced Level in all of these product areas may be beyond a number of these banks, especially in areas such as Project and Property Finance that require complex modelling to comply. Some of these banks may sell some of their portfolios to other banks who have managed to comply in the relevant area, and focus on an area where they themselves are able to comply at the Advanced Level. As banks become more specialist, some of the large number of small, generalist banks in London may be driven out unless they can identify specific and specialist areas where they can compete.

Basel II has less effect in the areas of Treasury and trading. Most trading operations in London have already implemented types of VaR (Value at Risk) calculators required to measure and manage trading risk and capital allocations for Market risk capital. It is not expected that the Basel II accord will have a major employment impact in this area.

Basel II: Summary

In the short term, it is to be expected that there will be more recruitment in London of highly qualified "Quants." In the longer term, banks not able to comply at the Advanced Level may be forced out of the London market, and certainly it will become still harder for new, overseas entrants to gain a foothold. Small generalist banks may be forced to focus on fewer areas. The total employment impact over the next decade may be hard to quantify, but the type of employment set to grow requires high levels of numeracy rather than the more traditional liberal arts background of many of today's front office bankers.

1.2 Regulation

Regulation of banking activities in London has changed significantly in recent years, shifting from a system of informal discussions with the Bank of England to a more formal system of compliance reporting with the FSA. In addition to the changes envisaged by Basel II (see above) increased regulation is being driven by:

- Recent high profile trading or miss-selling cases.
- High profile cases of fraudulent activities by corporate borrowers.
- Raised concerns about money laundering due to terrorism and international crime.
- An increasingly litigious environment (with the regulator as a potential target).
- Increasing complexity of products being traded in London.

One of the main concerns of London based banks is compliance with the Know Your Customer (KYC) initiative, but there have been and will continue to be a range of initiatives, all of which, directly or indirectly, increase costs.

Small banks in London, complain of the burden of increased regulation that, effectively, puts them at a cost disadvantage to their larger competitors. Even the addition of 2 staff for regulatory compliance (about the minimum required), make a disproportionate impact on the cost base of a branch with less than 100 staff. It should be noted that, although branches with less than 100 staff account for less than 6% of banking employment in London, they represent over 63% of the foreign banks in London and may represent the future potential or 'seed capital' of the market.

Regulation: summary
Increased regulation will require at least 1 – 3 staff more per smaller bank or similar per product area in a larger bank, making an increase of 1,000 or 2,000 more compliance roles in the short term (2- 5 years) but may reduce the number of small banks and new entrants to London.

1.3 Geography

One of the key findings of the 2003 Radley Survey was the significant variation in performance by banks from different regions. Much is said about globalisation, and the trend towards greater uniformity in banks from very different economies is occurring but nowhere near as fast as some commentators have indicated. Simplistically, the world of banking can be divided into three main blocks; Anglo Saxon, Continental European/Far East and Emerging Markets.

This categorisation is broad brush and clearly there are exceptions to each however, there is a reasonable amount of data to support the following 'stereotype' conclusions.

1.3.1 Anglo Saxon

Banks from these countries (including, USA, Canada, Scandinavia, UK, Netherlands, Australia and New Zealand) tend to focus on shareholder returns as their primary goal. Often banks from these countries have implemented reasonably sophisticated profitability metrics and have also tended to focus on business areas where they are able to make a profit. Within this group of banks we can include some of the larger Continental European banks that have achieved bulge bracket status and have adopted more aggressive business models often through the acquisition of a US or UK investment bank. These acquired institutions have become the core of these European banks non-domestic corporate, wholesale and investment banking operations (usually headquartered in London or New York).

Relative Returns: Most branches/subsidiaries from these countries produced returns on capital at approximately the same level as their parent bank. Operations in London tend to be part of a global product or customer matrix with profitability measured and managed centrally. In the Radley Survey this was the most profitable segment of banks operating in London.

Capital Usage: Over the past few years one notable strategy pursued by many of these Anglo Saxon type banks is aggressive capital management that has resulted in a reduction in balance sheet usage either through more innovative products or effective origination and securitisation. The trend towards more fee-based business is driving banks to develop greater skills and this is driving the demand for specialised resources. There has been a trend among the more sophisticated banks away from generalist lending officers to highly skilled specialists. These skills include:

- Quantitative and risk analysis
- Financial modelling and analysis
- Structuring
- Legal

Some of these skills are provided internally within the banks while others come from a variety of external suppliers such as consulting and legal firms. The move away from simpler balance sheet lending has given London a virtuous cycle of improved structuring skills leading to higher profits and thus further employment growth in the higher skilled areas.

Consolidation and M&A: While there will always be some activity in this area there is no particular pressure or reason to expect many of the UK or foreign Anglo Saxon style banks to significantly reduce numbers through consolidation. We anticipate that most of the M&A activity among this group will be mergers of US banks with each other that may result in limited reductions where overlaps exist.

Likewise there are few scale advantages remaining for consolidation among top tier investment banks. Over the past two years there has been a reduction in activities and staff among the ‘aspirant’ investment banks that have not gained the scale or managed to create significant franchises. It is to be expected that there will be continued consolidation and a reduction in activities by some of these institutions.

Likely future in London: This group of banks probably represents the most stable core of both UK based and non-UK banks operating in London. There are few reasons to assume they will significantly alter the overall level of ambition or operations in London.

There is no sign that the cyclical nature of much of the investment banking business is disappearing and over time there will continue to be major fluctuations in the volumes of business across most investment banking activities. This growth and contraction represents a volatile business but the overall trend is likely to be growth. One of London's advantages is its flexible labour market that can adapt to this volatility without major structural problems. It is clear that over the past five years the ability of London to absorb the employment drought and glut has put it at a major advantage to Paris and Frankfurt and most US investment banks (along with a number of Europeans) have retrenched from these locations to London.

Given these banks' focus on profitability we may assume there will be a continuing trend towards improved efficiency that may result in either technology or outsourcing reducing back office staff but it is likely this will be offset by growth in demand for higher level, higher paid, front and middle office staff.

1.3.2 UK Banks

Most of the trends impacting UK banks are the same as those described for Anglo Saxon banks (3.3.1) however we should also consider the following:

- Economic growth activity in the UK as large banks tend to be a bellwether for the overall economy.
- Improved efficiencies in transaction banking. There is a long-term trend to reduce manual interventions in areas such as payments and custody. Improved usage of technologies such as imaging will continue to erode lower skilled jobs; likewise many of these tasks are being outsourced to lower cost geographies. Additionally, banks are continuing to encourage customers to use electronic and other remote systems to reduce human intervention. For example, we have seen a major reduction in jobs associated with cheque clearing through a number of means, including the encouragement of direct debit and cash card payments combined with electronic imaging. Several banks have now outsourced these types of activities.
- Further consolidation. It is unlikely that there will be consolidation among the largest of the UK banks other than through overseas takeover or merger and thus among these banks employment is likely to remain stable other than through refocusing lines of business or improved efficiency. Some of the mid size and smaller UK banks may be vulnerable to consolidation but other than the removal of duplicated head office functions this is unlikely to have much impact on employment or demand for space.

Transaction banking: London is a major centre for transaction banking, including mass/retail payments, documentary trade services, cash management, settlements and custody. While these services will continue to have a significant presence in London the trends towards greater operational efficiency, changing customer behaviour and outsourcing will erode London based jobs in these areas. Many of the clerical jobs associated with these activities have already been outsourced (for example cheque clearing) or consolidation in a few major global providers (for example custody) and many of the jobs have already moved to lower cost regions in the UK.

Business Process Outsourcing: Among smaller London based corporate banks (20 – 1,000 staff) outsourcing is unlikely to have a major impact on overall staff numbers or the requirements for space. For most corporate and investment banks the need for control and being able to handle complex deals mean that the advantage of automating and outsourcing are limited. Among the larger investment banks and UK retail banks it is to be anticipated that many jobs in clearing and settlement will disappear as a result of either improved end-to-end (E2E) technology or outsourcing to lower cost environments. Global dealing systems will allow treasury and other trading tasks to be repatriated to head office especially where salary costs are lower than London.

1.3.3 Continental Europe/Far East:

Banks from these countries (including, Germany, France, Italy, Spain, Belgium, Portugal, Japan, South Korea, and Taiwan) tend to have multiple measures of success that may include profitability, strategic alignment, balance sheet growth etc. The majority of banks from these countries in general have relatively poor metrics to measure performance when compared to the Anglo Saxon banks. Clearly there are exceptions to this basic categorisation but we feel the generalisation is supported by the data we have gathered.

Relative Returns: Most of the branches from these countries tended to be more profitable than their parent banks but they were, on average, about half as profitable as the Anglo Saxon group of London branches. Many of the banks in this segment have a different business mix to that of their parent organisation and therefore are not perceived to be part of the bank's strategy but more of a way to leverage 'surplus capital' and gain higher returns than are available in their home markets.

While some banks in this segment were part of a regional/global product or customer management group the majority were stand-alone organisations that had developed their own customer relations and/or products. Evidence suggests that this lack of integration with the core banking business can leave the London branch vulnerable to strategic decisions made at head office. Thus some banks reported that in 2003 they were forced to reduce lending activities in London as a result of balance sheet problems at head office.

Capital Usage: The rationale for many of these banks to have branches in London is created by the relative efficiency of London's capital markets when compared to many other economies. In recent years these banks have been among the largest placers of capital into the London market but this may be changing. In the past year there has been a reduction in the size of balance sheets by many banks in this segment. So far this is not the result of a change in business strategy but merely a reduction in overall activity. There are clear indications that this trend is now reversing and many institutions are beginning to flow capital back into London.

In much of Europe and Asia wholesale banking margins are under half of those that can be achieved in London thus there is a strong incentive, for example, for a European retail savings bank to place capital in London rather than in local capital markets. One might expect this relative advantage of London to disappear but so far it has proved to be resilient and long lasting. Over time it may be anticipated that a number of factors will erode London's advantage, these include:

- Basel 11 which will force all banks to account for risk and capital in the same way thus margins should converge around the same risk/reward curve no matter what the geography.
- Greater shareholder pressure on the boards of banks that will force management to show how their growth goals link to shareholder value creation.
- The reduction in state banking subsidies that will remove market distortions and very low banking returns in some countries.
- The reduction in 'national champion' status and protection that many countries place around their larger banks that allows the management of these banks to perform below that of their Anglo Saxon peers without the threat of takeover by more efficient management.

Consolidation and M&A: For many years there has been an anticipation that there will be a significant reduction in the number of Continental European banks, over the past two years there has been some reduction in the number of Italian, French and Japanese banks and there is some pressure for further consolidation, particularly among German banks, but this has been slow in coming. The resistance of many governments to foreign takeovers, restrictive employment laws, the persistence of cross-shareholding and other governance issues has and continues to act as a brake on further consolidation.

Likely future in London: While the above represents a rational world view, many of these pressures have existed for some years and changes have been very slow and have yet to have had any discernable impact. In the short term it is unlikely there will be major changes in this segment but in the longer term it is likely that there will be a reduction in activity among this group of banks.

1.3.4 Emerging Markets.

Evidence suggests that the most vulnerable group of banks operating in London come from emerging economies (such as South Africa, Turkey, Jordan, Israel, Gulf States, Philippines, Thailand, India, and South America etc). Apart from South African and Middle Eastern banks these are typically small operations with a limited presence in London.

This is the least homogeneous of the groups of banks with a wide range of reasons to be in London, diverse products and customers. The common features are:

- London is less profitable on average than head office.
- Basel 11 represents a considerable threat to their competitiveness because the majority will not be able to benefit from lower regulatory capital under the Advanced IRB status.
- The changes in taxation that came into effect in 2003 requiring capital to be fully accounted for in London has significantly reduced profitability of many institutions. Emerging market banks have been disproportionately affected by the new tax regime.

Relative Returns: The majority of banks in London that originate from the emerging markets typically have lower returns in London as the lending risks are lower in London and they tend to have the expertise and local knowledge to manage higher risks/higher margins in their domestic markets.

Capital Usage: Unlike the Continental Europeans, Emerging Market banks tend to be relatively cautious in their use of capital (excepting banks from commodity rich states such as oil producers) and have business models that are linked to the needs of their home economies (trade finance, infrastructure project finance, salary remittance, private banking, commodity finance etc.). For some of these product areas London remains a good place to continue these activities but there is a threat from the increasing cost of compliance and Basel II.

Consolidation and M&A: It is unlikely that a major cause of the reduction in the numbers of Emerging Market banks will be driven by consolidation but it is highly likely that there will be a major rearrangement of lending portfolios that will result in fewer staff being required overall. Many small and mid-size lending portfolios will effectively be sub-scale when the cost of compliance (especially Basel 11) is taken into account. Additionally, as most of these banks will be either Standard or Foundation level under Basel 11 they will find many lending portfolios have become uneconomic and will thus sell, move to another geography or close them down.

Likely future in London: It is to be anticipated that in the short to medium term many banks from emerging market countries will examine their London based operations and reduce activities here. Where today we find 'mini universal' banks providing a range of products, in future these institutions are likely to reduce head count and activities to only those that are essential in London.

Geography: summary

Anglo-Saxon banks are likely to stay and are not expected to consolidate much further. Continental/Far Eastern banks may stay in London because of better returns than in their home markets but are likely to consolidate and specialise. Some emerging market banks may withdraw and fewer new entrants to London will be attracted as Basel II and increased regulation begin to bite. Changes in employment levels of UK Banks in London may be small but with a continued small drift away from London if costs remain high. There is likely to be a shift from lower skilled to higher skilled roles and in particular a demand for analytical skills.

1.4 Third Party Suppliers

There are a very large number of external suppliers to London's financial services industry. While we have not focused on this area between 12% (Lombard Street Research) and 23% (cebr) of 'city-type' employees in London are employed in supporting services, depending on the definitions used, for example:

- Information Technology: Developers, systems architects, systems integrators, business process outsourcing, data centre providers etc.
- Legal

- Consulting: Product development, strategy, risk management, compliance, technology, organisational, benefits and HR, marketing etc.
- Head hunters
- Public relations and advertising
- Audit and accounting
-

It is anticipated that as the corporate and wholesale market moves further towards structured products and the advisory side of banking the demand for some of these services will continue to grow. With the greater demand for high skill levels in some areas such as risk management and new technology banks will be encouraged to use even more external suppliers. It is the clustering of these services that provides London with one of its greatest strengths.

Technology services: Technology continues to provide one of the backbones of the banking industry. There are three main areas that can be identified:

- Business and technology consulting
- Development
- Code writing
-

These activities have traditionally been provided from both within banks and by external suppliers. The trend towards greater outsourcing of these activities is continuing with the 'high end' such as business consulting, systems architecture and development activities remaining in London. The more standardised processes are likely to migrate to lower cost environments (code writing, data centres and help desks).

Analytical research: There has been a recent trend to take some of the highly intensive research tasks that can be done with information that is available electronically to remote areas such as India where a highly educated work force is able to produce equity research and other analytical tasks at a fraction of the costs of London. This is partly driven by a lack of quantitative staff in London.

Geographical Consolidation: There has been a trend among banks to consolidate activities into major centres. In general London has been a beneficiary of this trend with European activities being centred in London at the expense of Frankfurt and Paris.

1.5 Efficiency and Innovation

By following the analogy of other mature industries, one might expect to see product standardisation, consolidation, process automation and economies of scale in the London banking market leading to reduced employment. The fact that employment in financial services in London's Central Business District (CBD) has grown by over 48% in last decade attests to the growth in London's product offering and financial innovation. New products proliferate creating new employment faster than processing efficiencies for existing products reduce them. This observation may invite two questions: Will financial innovation continue – or was it a by-product of the booming '90s? And will technology-driven efficiencies accelerate?

Need for innovation:
The rate of financial innovation in the London market has been fairly consistent since the 1970s. The bank's end customers have an almost insatiable appetite for reducing risk and as the methodologies for more accurately measuring and quantifying risk gather pace, new offerings will almost invariably follow. Just as work by Black-Scholes in options pricing lead to the emergence of the Options market, the work of others is leading to more precise measurements of other types of risk. On the back of this we may expect whole new categories to emerge in London. The emergence of the Hedge Fund industry or Credit Derivatives trading are good examples of this trend. In particular, the insurance industry tends to follow banking in developing risk measures and therefore tradable instruments, but the development in the US of risk derivatives (for example for weather) may push the London markets to compete. The needs of insurance funds and pension funds to find their way out of their current crises should lead to a new wave of financial innovation. The causes of financial innovation include:

Cause	**Example**
➢ Changes in capital costs through regulatory changes	➢ Basel II
➢ Increased computer power	➢ Monte Carlo simulation of risk
➢ Methodologies for risk measurement	➢ Black-Scholes
➢ Adapting successful instruments for other markets and needs	➢ Catastrophe derivatives
➢ Demand for new solutions from changing customer sectors	➢ Insurance and pensions sectors
➢ Innovative products continuing to be the most profitable	➢ Hedge funds margins vs. standard pension margins

It is reasonable to assume that none of these factors are likely to lose their impact in the near future, so, subject to general slowing of the market due to poor economic performance, innovation is likely to be at least as strong in the next decade as it was in the last. The growth in innovation tends to attract the most highly qualified (and expensive) staff of all.

Efficiency gains will also continue, but the scope here is possibly less. Back office efficiencies may be made by automation or outsourcing. Automation is now high for most easily automated processes and anecdotally does not rank high on corporate or wholesale banker's lists of priorities. New products usually require manual processing until the volume picks up so new jobs are always created for experienced and or adaptable clerical staff in commercial banks. In the retail sector many tasks are already automated and done in lower cost environments than London. For those areas of highly intensive processing such as securities and custody we have already seen significant concentration in the hands of a few very large custody and transaction organisations and banks. With improved clearing and straight through processing this trend will continue but given the amount already achieved in these areas it is unlikely to have a major impact on employment in London.

General Managers of foreign banks do not usually have outsourcing at the top of their agendas. In the Radley Banking Survey although most foreign banks keep the majority of their back office activities in-house in London (see fig 1), only 15% expected to outsource more back office activities, 6% to outsource less and 79% expected no change. Most banks express poor satisfaction with their experience of outsourcing, and, paradoxically, many London operations see themselves as too small to manage outsourcing effectively. Most importantly of all, although back office processing costs typically account for about half of a branches operation costs, its operational costs are in the order of a third of their capital costs, so all back office costs account for less than 13% of overall costs and processing costs of the type that could be outsourced probably account for less than half of this. Individual functional variations are discussed below.

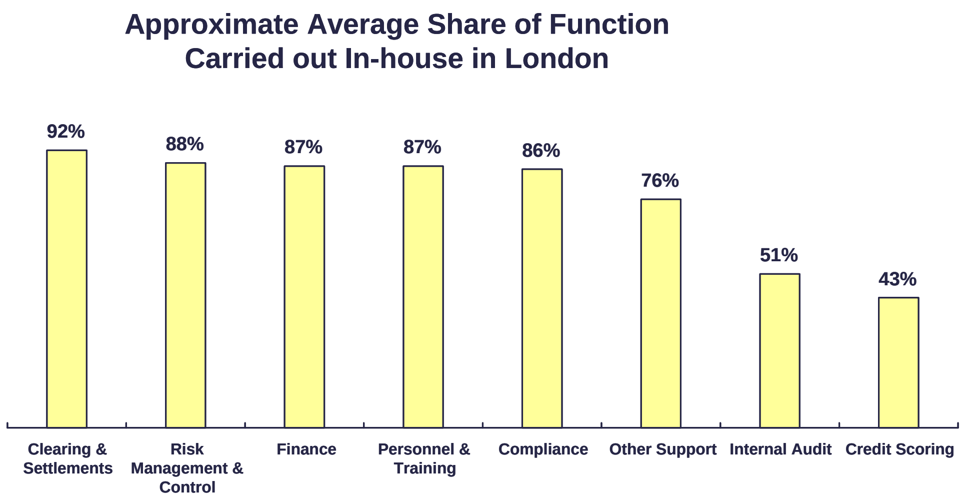


Figure 1

For UK retail banks, the story is different and there is a considerable trend towards outsourcing call centre and processing activity abroad. Most of this activity has, however, long since moved out of London, and, with the exception of Private Banking the trend is unlikely to impact employment in London.

Innovation and Efficiency Summary

The growth of product innovation is probably the single biggest factor affecting the growth of employment in London. Although hard to quantify, it is also hard to argue that it should drop below the levels of the last decade. Efficiency gains, by comparison, are now relatively low and not critical to cost competition and therefore unlikely to reduce back office employment as fast as new products increase the demand for back office staff.

1.6 Attractiveness of London to foreign Banks

In this section we ask: why do Banks come to London and will they continue to do so?

General Managers interviewed by Radley & Associates tended to regard London as one of the world's most important financial hubs. Overall, respondents felt London's role as a centre of development and activity in world financial markets provided key benefits:

–"We're in London because it is one of the main financial centres of the world. We also need to be near international developments which happen earlier in London than in our home country….PFI, for example" (European bank)

–"There is better access to investment sources here since a lot of deals are implemented in London…and the flow of information on [bigger] transactions is better and a lot can be done having a beer with your colleagues…" (European bank)

For relatively sophisticated banks from small domestic markets, the size of London's financial markets was particularly attractive:

–"We are the biggest bank in our domestic market so we have to expand off shore, and there are very few markets for us to expand in….and the UK is particularly appealing since the tax and regulatory environment is familiar" (Asia/Pacific bank)

–"[Home region] is a small market…so the UK is a core market for the future since you run out of room to grow…" (European bank)

–"Growth is limited in [home country]….the US is very competitive so we need to find other sources of growth" (North American bank)

–"[Home country] is a melting iceberg….it's saturated….where can we grow?" (North American bank)

Balance sheet diversification was cited as a secondary but still important goal by the more sophisticated institutions as a reason for building an asset portfolio in London; providing that reasonable returns are possible and regulation remains benign.

London was also viewed as a major source of product and process innovation

–"London is used for product innovation, e.g. PFI" (Asia/Pacific bank)

–"In London there's the Anglo-Saxon 'innovation'….[home country] is a backwater compared to this" (European bank)

–"London has been a driver of innovation in cases too numerous to list, but some examples are: customer relationship management….separating credit analysis from business development….looking at return on capital…." (European bank)

–"In Frankfurt everything is illegal until the regulator makes it legal: In London everything is legal until the regulator makes it illegal"

However, some found high costs—for staff, premises and other resources—and regulatory requirements particularly challenging

–"There are difficulties hiring at the rates we have to pay in London….and this is becoming more transparent [within our organization] globally and this can cause resentment. But if we can't offer top bonuses, we lose our best traders." (European bank)

–"We're beginning to get regulatory fatigue from filling in forms…" (Emerging markets bank)

Weak currency zones and heavily subsidized or inefficient domestic markets make London an attractive capital market. Banks from countries where state intervention in financial markets is high tend to rate *access to liquid markets* more important than banks from other countries. But banks located in weak currency areas cited 'hard currency' earnings as a reason for participating in the London lending market. In particular, banks from emerging market economies saw London as a critical source of hard currency for bank funding purposes. For emerging market banks another reason to have a presence in London is to originate lower risk assets to provide an improved risk profile for their balance sheets.

Banks from countries where state intervention is low tended to rate business, not market-related, reasons more highly as primary factors, e.g. serving client needs.

Despite consensus about the importance of London itself, London branches did not see themselves as important to overall bank strategy. On average, respondents regarded the London branch as only moderately important to the success of the bank's overall global strategy. The less integrated the branch was into the overall organization, the less important branch staff believed it was: autonomous branches and branches from regionally organized institutions where London was more likely to set its own strategy saw themselves as only moderately important on average (4.4 on a 1 to 10 scale, where 1 = extremely unimportant))

—"We're largely left to ourselves…we're a glorified post office"

But branches from matrix organizations where strategic decision-making was more centralized tended to see themselves as relatively more important (7.1 on a 1 to 10 scale, where1 = extremely unimportant)

There was broad consensus that the UK's joining or staying outside the Euro would not affect London as a financial centre. Across the board, interviewees felt London's decision to enter or remain outside the Euro would have no or very little impact:

–"If the UK joins, there'll be some decline in [trading] activities in London….But for the foreseeable future, London will be strong—the skills are here…" (European bank)

–"The Euro will have no impact" (European bank)

–"[Home country] has no idea about the Euro….and I don't think we've lost any deals because of the UK's decision [not to enter the Euro]" (North American bank)

–"The introduction of the Euro won't make any difference to us" (Emerging markets bank)

–"I don't buy the Euro argument. For European banks there's still logic for a London branch" (North American bank)

–"The Euro will have no serious effect" (Asia/Pacific bank)

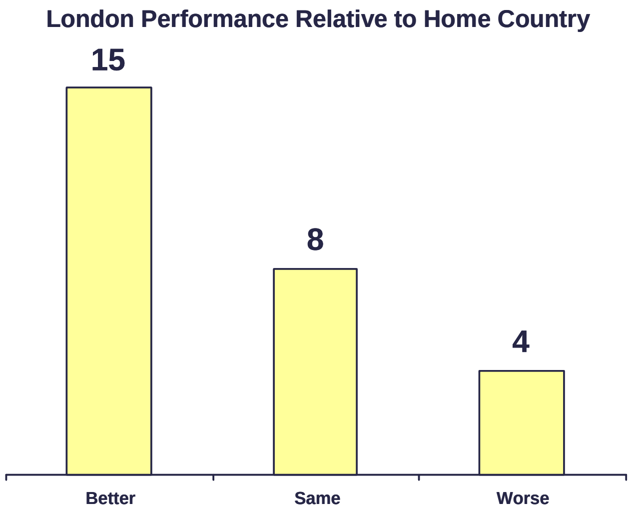
Indeed, many banks had or were consolidating European operations in London—and in-Euro-zone banks were no exception:

> –*"The Euro will have no impact…particularly as we are moving from a geographic to a global sectoral organisational structure with sectors to be based in London" (European bank)*
>
> –*"We've been consolidating all European operations back into London…the other [European] branches we had were not meeting hurdle rates…and we felt we didn't need the bricks and mortar" (North American bank)*
>
> –*"We closed our European branches [in the 1980s]…we're the focal point for lending in Europe" (North American bank)*

General Managers were generally cool on the attractions of other global financial centres. Frankfurt was generally singled out for over-regulation and Paris for the inflexibility of its employment laws.

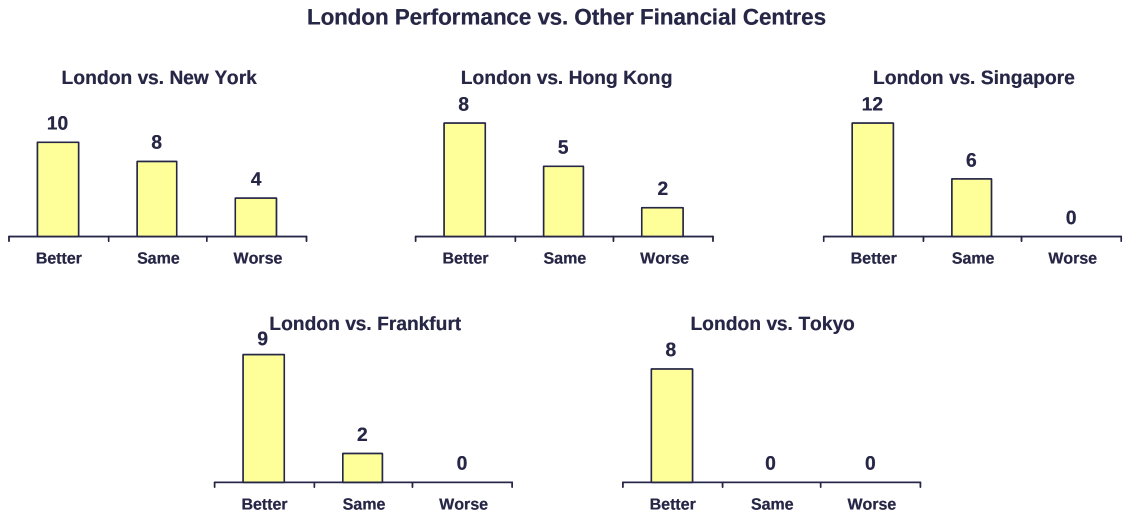
> –*"Frankfurt will never become the centre though the Germans are making a big push for it. London has advantages, but if the FSA becomes too oppressive, then people will think of moving out" (European bank)*

Most managers believed London to be a more profitable operation than their home country and more profitable than any other global financial centre (with New York a close second).



"Generally speaking, do you believe London performs better or worse than similar operations in your Home Country?"

Figure 2



"Generally speaking, do you believe London performs better or worse than similar operations in other Financial Centres?"

Figure 3

With the exception of two types of bank, none of the banks interviewed by Radley & Associates had plans even to consider withdrawing from London:

- Small, emerging country banks face effective double taxation of their London profits and are actively looking for ways to do or book business elsewhere. Although this type of bank accounts for less than 1% of foreign Bank employment in London, again, they may represent the City's seed capital.
- The other category of banks is those, mostly French, German and Italian banks that have suffered losses or poor profitability across the entire bank. These banks are retrenching to shore up their capital base or shifting strategy to focus on their core markets rather than because of any underperformance in London.

Attractiveness of London: Summary

London remains attractive to foreign bankers because they believe that London still:

- Offers more attractive opportunities than at home
- Is where the market is
- Will not be affected by a Euro decision in either direction
- Is a centre for financial innovation
- Is not too onerously regulated.

London is still considered a better place to do business in than the main European alternatives. It may be safe to conclude that London will not loose its attraction given the important proviso that these advantages persist.

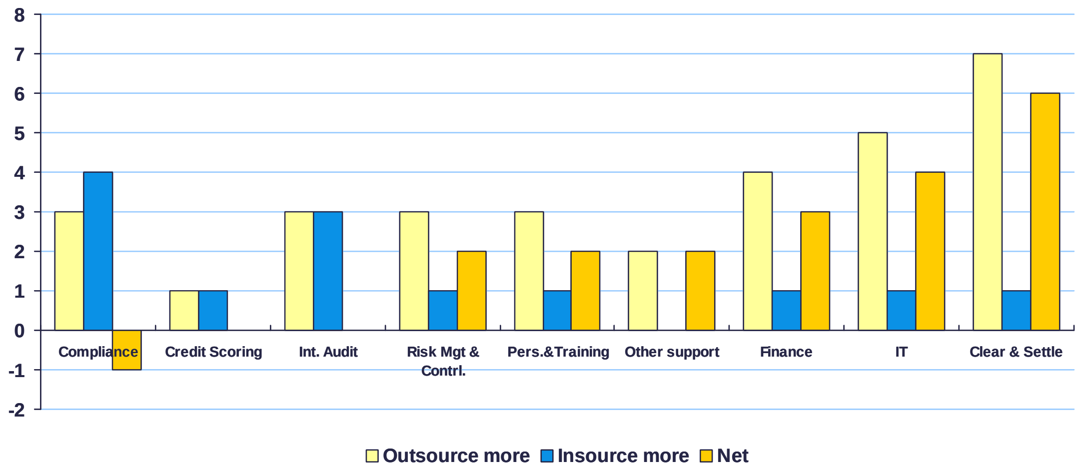
2 Functional Impact

In this section we ask, what are the main trends affecting each type of support function and how likely are jobs to stay in London?

For corporate and wholesale banks most back and middle office activities are carried out in-house, in London. For the purposes of the following analysis, 'outsourcing' includes moving activities from the London branch to the home country head quarters.

Figure 4

Outsourcing Intentions by Activity



2.1 Clearing & Settlements

Clearing & Settlements activities expect the highest level of out sourcing but even here, less than 20% of banks expect to outsource further. Most existing clearing and settlements staff in London deal with exceptions rather than with straightforward transactions and being close to the customer (e.g. being in the same time zone) may be critical.

2.2 Risk Management

Risk Management staff are likely to increase significantly, driven by Basel II compliance (see above) and by a general shift from lending based on loan officer judgement to careful risk quantification. Although the main Basel II compliance projects are typically driven from head office, Risk Management staff will be required to implement and monitor risk measurement at all levels. This may be on of the largest growth areas in Commercial banking.

2.3 IT

IT staff continue to grow although there has been some successful examples of IT outsourcing – especially for development. However, outsourcing to consultancies is unlikely to shift all jobs out of London, since many IT consultancies are based in London near their banking clients. Bank's systems are always evolving and large IT contingents have become an entrenched feature of most banks. Few if any banks have spare internal IT resource and IT projects typically wait in long and complex queuing/prioritisation systems.

There has been a growing trend towards outsourcing to cheaper but highly educated labour markets such as India or Vietnam. This has affected work such as IT development, especially code writing, and we expect this trend to continue as companies become more experienced in managing complex cross-border programmes and technology improves.

However, we anticipate that the higher skilled tasks of design and architecture will of necessity remain close to the product development teams and end users in London.

Larger global banks have attempted to install consistent systems across their branches world-wide in an attempt to provide greater consistency. The main reason for upgrading systems to a common platform is to allow for more seamless product delivery on a global basis but it also has the effect of allowing certain work to be centralised. Thus for the largest banks we should anticipate the loss of some IT jobs to a central location outside of London. This centralisation will be most apparent in the areas of cross boarder cash management, treasury services, custody and dealing/settlement systems.

2.4 HR

HR staff (training & personnel) numbers are unlikely to change much as there are few HR driven initiatives high up bankers agendas and there are no major government initiatives currently affecting the employment environment. Most clerical HR jobs have already been outsourced (e.g. payroll) in all but the smallest banks. London banks expect a very modest bias towards moving HR jobs to the centre.

2.5 Credit Scoring

Credit Scoring is one of the few activities which are already centralised to a single bank-wide credit department, and for foreign banks this usually means in the home country head quarters – primarily as a means of central credit control, although the level of delegated lending authority to London varies widely depending on the approach and philosophy of the bank. A number of roles that used to be considered Credit Scoring may be wrapped into the Risk Management function. For UK based banks and banks that run key lines of business out of London there are likely to be requirements for additional skilled staff in these areas.

2.6 Finance

Finance function employment in Banking is driven chiefly by the need for ever more sophisticated cost, capital and profitability measures. Most banks are renewing their Management Information reporting capability on an almost perpetual basis. Once, product line profitability reports can be generated and trusted, banks begin to request customer profitability reporting, firstly in P&L terms and subsequently in Return on Capital and Risk Adjusted Return on Capital (RAROC) terms. Many have adopted more sophisticated Activity Based Costing reports. One of the largest changes afoot in banks in advanced countries is the move to RAROC systems. These are typically computer intensive and technical and a pre-requisite for Basel II compliance, so the pressures on the banks to adopt are strong. The range of reporting sophistication in London varies hugely so there remains much to be done in Finance functions (and by their consultants) to catch up. It is possible that those banks unable to catch up will be the most likely to leave London. Sophisticated, risk-adjusted profitability measures give the advanced banks the ability to sell on poorer assets to less capable banks – concentrating the risk (in some commentators views) amongst the very banks that are least able to manage it. It is hard to argue a case for smaller finance functions and less than 6% of banks expect to centralise this function or outsource it further.

2.7 Compliance

Compliance officers, though accounting for less 1% of banks staff are likely to increase in number due to the increasing level of regulation (see Increasing Regulation above).

2.8 Internal Audit

Likewise, the Internal Audit function is set to expand from a small base.

2.9 Summary of Review by Function

It should be noted that all those areas set to expand the fastest (Finance, Risk Management, Internal Audit) require highly numerate staff, often with multiple degrees (not limited to Science PhDs, Finance and MSc). Most areas set to stagnate or retract are less highly qualified.

Estimates of growth across the whole Back Office banking area could be in the region of 0% to 8% a year; all other factors being equal.

	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%**

Figure 5

3.0 Conclusion

The authors conclude that the number of staff employed in London (and hence requirement for office space) is likely to continue to grow in the medium to long term. Employment is expected to shift from more low skilled to more high skilled staff and comprise fewer liberal arts graduates and more mathematically literate staff. Most banks expect to grow employment in the short to medium term.