LONDON: WINNING IN A CHANGING WORLD

REVIEW OF THE COMPETITIVENESS OF LONDON'S FINANCIAL CENTRE

contents

Foreword from the Panel Chairman, Bob Wigley

I have been lucky enough to work in London's financial services industry for the last twenty-five years – a period during which London and the wider "City" of UK financial services has grown rapidly, providing rewarding careers for many and a growing and substantial contribution to the UK economy and Exchequer.

As recently as 2006, the City was congratulating itself on having developed a position as arguably the world's leading financial centre. The environment seemed set for this lead to be extended or at least maintained. Over the past two years however, London's position has been threatened by the rapid development of Middle Eastern and Far Eastern economies, the targeted strategies of other financial centres and New York's reassessment of its own competitive position. More recent developments – Northern Rock, the Non-Dom and Corporation Tax consultations, the Icelandic bank and Lehman Brothers collapses – have struck at the heart of confidence in London. We can no longer take it for granted that our capital will be seen as a trusted place to do business against the backdrop of a competitive, predictable, constructively applied tax regime, a world-revered financial regulatory regime and an open, transparent and fair legal system.

Given the significance of the City's contribution to the UK – not least in the form of tax revenues, employment, community support and arts and sports sponsorships – this must be a very serious concern to the authorities.

It was therefore timely on the election of a new Mayor for London, for him to ask me to convene a panel of leading Chief Executives from every sector of the UK's financial services industry to consider how the City could ensure it maintained its lead in the decade ahead. This non party political report seeks to address the issues which businesses in the City regard as fundamental. As the European Chairman of a leading global financial services firm, I know what drives firms like mine to locate business in London as I regularly face the choice of whether to do so or not. I hope this report will be welcomed by my industry colleagues, the Mayor, the City of London Corporation and political leaders as an objective and constructive contribution to policy development. I thank my panel co-participants for their hard work during an extraordinarily demanding period in the markets, thank all those who were interviewed or otherwise contributed to the sector panels and thank McKinsey & Company for providing the fact base and analysis for the report.

I very much hope this report will inform the longer-term review being conducted by the Chancellor's High Level Group (the chairman of which I have kept closely informed of our work) and that our policy recommendations will be aggressively pursued.
If they are, I have no doubt that London can restore its reputation and maintain its competitive advantage to the benefit of those who work in it or are indirectly employed or funded by its participants and its tax contribution.

I know I can rely on my senior industry colleagues to recognise our collective responsibility to engage proactively with and support regulators, the Bank of England, HM Treasury and the Government to rebuild London's reputation and competitive advantage.

I have been lucky enough to work in London's financial services industry for the last twenty-five years – a period during which London and the wider "City" of UK financial services has grown rapidly, providing rewarding careers for many and a growing and substantial contribution to the UK economy and Exchequer.

Members of the Review Panel

MEMBER	ROLE AND ORGANISATION	SECTORS REPRESENTED
BOB WIGLEY (Chairman of the Review Panel)	Chairman for Europe, the Middle East and Africa, Merrill Lynch	Investment banking, global markets and private wealth management
SIMON FRASER	President, Fidelity International	Asset management
STUART FRASER	Chairman of the Policy and Resources Committee, City of London Corporation	
JOHN GRIFFITH-JONES	Chairman and Senior Partner for Europe, the Middle East and Africa, KPMG	Accountancy and taxation
LORD PETER LEVENE	Chairman, Lloyd's	Wholesale insurance
DAVID LEWIS	Former Lord Mayor of the City of London and former senior partner, Norton Rose	Legal
HARVEY MCGRATH	Chairman, London Development Agency and Chairman designate, Prudential plc	
ANDREW MOSS	Chief Executive, Aviva plc	Retail insurance
MANNY ROMAN	Co-Chief Executive Officer, GLG Partners	Hedge funds
JOHN VARLEY	Chief Executive, Barclays plc	Retail banking, global markets and private wealth management
HELEN WEIR	Group Executive Director, UK Retail Banking, Lloyds TSB plc	Retail banking
PHILIP YEA	Chief Executive, 3i Group plc	Private equity

Executive Summary

In June 2008, the Mayor of London, Boris Johnson, launched the Review of the Competitiveness of London's Financial Centre and asked its authors to make clear recommendations on how the capital could best sustain and strengthen its reputation as the "global capital of finance". The financial crisis that has struck the world in the intervening six months has heightened the importance of this task.

To deliver on its remit, the Review sought the perspectives of 100 of the financial services industry's leading chief and senior executives and commissioned extensive primary and secondary research. This report is the output of that work and covers four main topics:

1. The factors that have historically made London a global financial capital and major contributor to the UK economy
2. Threats to London's financial capital leadership
3. Recommendations on actions that London can take to strengthen its long-term competitiveness
4. Practical steps that leaders in government and in industry need to take to implement these recommendations

London: global financial capital and major contributor to the UK economy

The Review stepped back from the current market turbulence to examine what historically had driven London's global leadership in financial services. It sought to answer three questions.

What defines London as the "global capital of finance"?
London's financial centre has two important roles – as the headquarters of the UK's domestic financial services industry and as a hub for international wholesale finance. It is the second role that makes London truly unique, creates the majority of the capital's financial services jobs and acts as a magnet for capital and talented people from around the world. The UK has the largest international capital flows of any country in the world. London and the UK enjoy global dominance of important financial products such as cross-border bank lending and foreign exchange turnover.

What is it worth?
The financial services sector's overall economic contribution has grown steadily in recent years, making up almost a tenth of the UK's gross value add in 2006. The sector employs some 1.3 million people in the UK – 500,000 of them in the capital. London's financial services contribute 11 percent of the UK's total income tax and 15 percent of corporation tax, more than the UK's schools budget or NHS wage bill.

What drives London's financial leadership?
The executives interviewed indentified four main strengths that have underpinned London's financial leadership, and that must be safeguarded in future:

1. A supportive tax, legal and regulatory context
2. The capital's attractiveness as a location for leading corporations and financial institutions
3. Effective systems and support services, including technology, media and professional services
4. A deep talent pool and welcoming culture

London under threat

The Review's interviews and research indicated that several of these strengths had been declining well before the crisis started. A group of competitor cities have been developing increasingly aggressive strategies to attract particular categories of business away from London. The crisis has exacerbated these threats and led to additional challenges.

Deterioration in London's historic strengths

London's historically supportive context is threatened by the increasing influence of pan-European regulations, reducing the UK's ability to position itself as competitively as it could in a fragmented EU regulatory environment. The UK's reputation for predictable, favourable and constructively applied taxation has also been declining. London has become less attractive as a business location, owing to an eastward shift of global wealth and local factors such as the "non-dom" levy, higher income tax, transport bottlenecks, living costs and skills gaps.

Intensifying competition from other financial centres

New York is regrouping and a series of niche, regional and national centres are targeting different aspects of London's business across a range of industries and products. Many of these centres benefit from tax rates significantly lower than the UK's. Some, such as Dublin, Luxembourg and Bermuda, are targeting particular subsectors through grants or incentives. These centres are typically more strategic, co-ordinated and assertive than London in their promotion efforts.

Risks to London from the financial crisis

A series of developments including Northern Rock, Lehman and the Icelandic bank collapses have struck at the heart of confidence in London as a place to do business. The crisis creates the risk of ill-conceived or unduly restrictive new regulation with an impact over and above the existing trajectory of EU-driven regulation. There is the additional threat that overseas banks retrench and consolidate further, refocusing their operations on their domestic markets.

How London can win in a changing world

The Review assessed a range of proposals and identified five major initiatives that London's – and the UK's – leaders should consider implementing.

1. **Rebuilding the UK's reputation for leading global financial regulation**
   In the wake of the financial crisis, the industry and regulatory authorities must act together to rebuild the UK's reputation. The industry must support the Financial Services Authority's planned move from risk-based supervision to a more intense supervisory model and do all it can to support the creation of a new global regulatory framework. The Government must urgently review the UK's administration laws to restore trust in London-based financial services subsidiaries of overseas firms. Statutory immunity must be granted to whistleblowers as one step to establishing "credible deterrence" to insider dealing.

A group of competitor cities have been developing increasingly aggressive strategies to attract particular categories of business away from London.

2. **Creating a single powerful board to promote London as a financial centre**
   The Review recommends that London form a single powerful, properly resourced financial services representation board under the leadership of the City of London Corporation, bringing together the financial services elements of existing overlapping groups. This body should be tasked with promoting London's financial services sector overseas, anticipating strategically important trends and highlighting to the domestic audience the industry's contribution to the UK. A chairman of top industry calibre should be appointed to oversee the new body.

3. **Boosting infrastructure**
   The Review recommends that the Greater London Authority set up a "financial services infrastructure group" which, in co-operation with the City of London Corporation, would plan for the long-term infrastructure needs of the industry. In particular, the group would co-ordinate a solution to the industry's fast-growing power and data processing requirements, potentiallly collaborating to establish a common data centre in London. This could give London-based firms significant latency, cost and scale advantages over other centres.

4. **Making London the location of choice for financial services careers**
   The Review proposes the development of a programme, led by the Chancellor's High Level Group, to ensure that London remains the location of choice for professionals starting and progressing their international financial services careers. The programme would also help London become the global centre for academic excellence in addressing emerging financial services issues, deepening the links between industry and academia and upgrading the facilities of the capital's universities. It should also strengthen London as a magnet for overseas talent, for example by bringing in top Indian and Chinese universities.

5. **Improving the competitiveness and predictability of the UK's tax regime**
   The Review developed three specific proposals for tax reform for consideration by HM Treasury:
   - Improve the process of introducing new tax policy
   - Use the tax system to reinforce the UK as the most attractive geographic location for companies to base their headquarters or regional holding companies
   - Set out a strategic policy for corporation tax to demonstrate the UK's intention to remain competitive in an increasingly challenging global tax environment

The authors believe that these proposals would, if implemented, create significant new employment and tax revenue.

Leading the way for London

The Review considered how each of its recommendations could best be phased and implemented, identifying immediate steps and milestones for the next one to two years and longer-term actions. It also identified complementary roles which the Mayor, the City of London Corporation, the Government and industry could play in leading these initiatives.

Introduction

In June 2008, the Mayor of London, Boris Johnson, launched the Review of the Competitiveness of London's Financial Centre, with this challenge to its authors:

> "London has an enviable reputation as the global capital of finance, but I want to make sure it is prepared for the great challenges facing us now and in the future. I am keen this group finds out exactly what the leading industry players think and makes clear recommendations to all those concerned with upholding one the UK's most important economic sectors.
>
> "It's vital that the capital retains its competitive edge amongst the world's leading financial centres in the years ahead."

The original remit of the Review had three parts. First, to consider London's competitive strengths across all the main financial services sectors, including retail banking, insurance, private banking, asset management, investment banking, private equity and exchanges. Second, to assess the threats posed to London's position, both from the actions of other cities and from challenges within our own environment. Third, to develop specific, practical proposals to sustain London's competitiveness in the long term.

In the intervening six months, the world – including London – has been rocked by a financial crisis of a scale that few might have imagined. The FTSE 350 UK bank index has lost more than half its value since April 2008, wiping almost £120bn off the market capitalisation of UK banks. Job losses have been quick to follow, with more than 60,000 job cuts across financial services announced to date in London alone. In October this year, HM Treasury announced an additional £37bn investment in major UK banks. While the Review's original remit – to advise on London's competitiveness as a financial centre – remains as relevant as ever, the terrain on which London will be competing has now shifted dramatically. The authors have therefore considered the unfolding impact of the crisis and current efforts to restore confidence, while remaining focused on shaping proposals to strengthen London's long-term position.

> "London has an enviable reputation as the global capital of finance, but I want to make sure it is prepared for the great challenges facing us now and in the future. I am keen this group finds out exactly what the leading industry players think and makes clear recommendations to all those concerned with upholding one of the UK's most important economic sectors."
>
> —Boris Johnson

To deliver on this remit, the Review gathered data from a range of authoritative sources. It sought the perspectives of close to 100 of the financial services industry's leading chief and senior executives through interviews and workshops. (The interviewees included the members of the Review panel, listed on page 45, as well as a diverse group of other senior executives and experts, listed in Appendix 1). McKinsey & Company was engaged to provide independent, fact-based analysis to inform the Review panel's considerations. Building on the resulting primary and secondary research, the panel examined London's financial centre sector by sector; considered the strengths and competitive positions of London and of rival financial centres; and assessed the evolution and likely impact on London of a range of long-term trends, including global economic shifts and improvements in technology.

This report is structured in four chapters.

Chapter 1, **"London: global financial capital and major contributor to the UK economy"**, takes a step back from the current market turbulence to reflect on the characteristics that have made London a unique financial centre – a truly international wholesale financial hub alongside a powerful domestic financial services industry. It quantifies the substantial contribution that the City makes to the UK's economy through wealth creation, jobs and tax revenues.

The chapter also analyses the factors – commercial, legal and human – underlying London's distinctiveness as a financial centre, that will need to be safeguarded and strengthened in the future.

Chapter 2, **"London under threat"**, shows that – well before this year's financial crisis – some of the factors which have historically driven the competitiveness of London's financial centre had been deteriorating. It analyses how local factors including EU regulation, tax changes, living costs and transport have threatened some of London's historic strengths. The chapter assesses the intensifying competition that London's financial centre faces from cities elsewhere in the world. It shows how these threats to London's position have been compounded by new risks posed by the financial crisis – including job losses and the risk that foreign companies listed in London retrench back to their home countries.

Chapter 3, **"How London can win in a changing world"**, contains the Review's recommendations. It looks beyond the immediate market turbulence and concerns itself principally with the actions that London can take to strengthen its long-term competitiveness. These include rebuilding the UK's reputation for leading financial regulation and creating one powerful board to promote London as a financial centre. Other recommendations focus on improving the competitiveness and predictability of the UK's tax regime; boosting infrastructure, particularly to support the industry's growing power and data processing requirements; and making London the location of choice for professionals starting or progressing their international financial services careers.

Chapter 4, **"Leading the way for London"**, sets out the practical steps that government and industry leaders can take to implement the Review's recommendations and so achieve tangible improvements in the capital's competitive position. The chapter proposes ways in which the implementation of the recommendations could be phased and suggests how responsibility for driving them should be assigned. Specific roles are proposed for industry, the City of London Corporation, the Mayor and the Government.

1. London: global financial capital and major contributor to the UK economy

This chapter steps back from the current market turbulence to examine what historically has driven London's global leadership in financial services. It also assesses the value of this leadership to the UK and to the capital. Drawing on the interviews and research conducted during the Review, the chapter seeks to answer three questions:

- What characteristics make London the "global capital of finance"?
- What is London's financial leadership worth – to the capital and to the UK?
- What are the factors that underpin London's leadership position – and that government and industry should safeguard and strengthen in the long term?

What defines London as the "global capital of finance"?

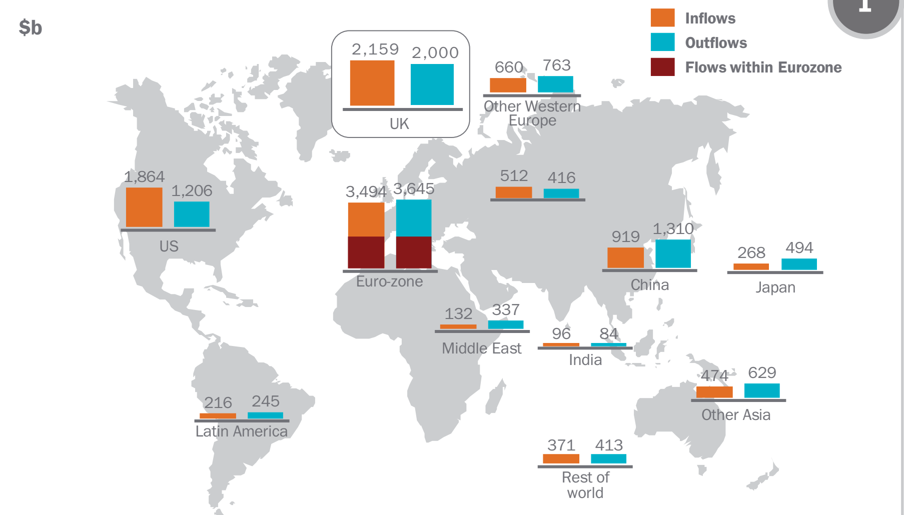
London's financial centre has two core roles – as the headquarters of the UK's domestic financial services industry and as a hub for international wholesale finance. The domestic industry – made up principally of commercial banking, retail banking and retail insurance – is an important sector in and of itself, employing some 150,000 people in London.

It is, however, as an international financial centre – made up of wholesale insurance, asset management, exchanges, investment banking, hedge funds, private banking and private equity – that London is truly unique. This wholesale centre creates the majority of London's financial services jobs – some 250,000 in total – and acts as a magnet for capital and talented people from around the world.

The UK has the largest international capital flows of any country in the world. In 2007, inflows into the UK stood at $2,159bn and outflows at some $2,000bn – easily outstripping those of the US, the UK's closest rival. (**See Exhibit 1**). These figures are reflected in London and the UK's global dominance of several important financial products (**see Exhibit 2**). For example, the UK is the market leader in cross-border bank lending (20 percent of the world total in 2007) and foreign exchange turnover (34 percent).

London's financial centre has two core roles – as the headquarters of the UK's domestic financial services industry and as a hub for international wholesale finance.

Exhibit 1: Capital inflows and outflows* by region, 2007



* Capital inflows and outflows are defined as the total amount of money invested into and out of a country during a given year in foreign direct investment (i.e. investments in more than 10% of equity), equity, debt, currency and deposits, loans, other residual flows, foreign trade credits, and foreign exchange reserve assets

** Includes Russia

Exhibit 2: Financial activity market share by country, 2007/2008

2

● Market leader

%

	UK	US	Japan	France	Germany	Singapore	Hong Kong	Rest of World
Cross-border bank lending	20	9	7	9	11	2	2	40
Foreign equities turnover	29	59	–	–	4	–	–	8
Foreign exchange turnover	34	17	6	3	3	6	4	27
Exchange-traded derivatives turnover	6	40	2	1	13	–	1	37
Over-the-counter derivatives turnover	43	24	4	7	4	3	1	14
Marine insurance net premiums*	20	10	11	6	8	1	1	43
Fund management (as source of funds)*	9	48	6	6	4	–	1	26
Hedge funds assets*	20	66	2	1	–	1	2	8
Private equity – investment value*	7	71	–	2	1	1	–	18
Securitisation – issuance by value	6	76	2	–	1	–	–	15

[1] March 2008
[2] January – September 2008

London is unique in the extent to which its financial markets are international. A glance at new listings on the London Stock Exchange, versus those of New York, its leading international competitor, neatly illustrates this point. No fewer than 14 of London's top 20 initial public offerings (IPOs) over the past three years were by non-UK companies. In contrast, just four of New York's top 20 IPOs were by non-US players. (**See Exhibit 3**). The UK's level of international financial integration – its foreign assets and liabilities as a percentage of GDP, as calculated by the International Monetary Fund (IMF) – stands at 960 percent, by far the largest of any of the G7 countries.

In addition to hosting this international financial hub and large domestic industry, London contains a powerful set of direct supporting industries, notably financial media, accounting, consulting and legal. Between them, these industries employ more than 150,000 people in the capital.

Exhibit 3: Top 20 IPOs ranked by value, 2005 – 2008 year to date

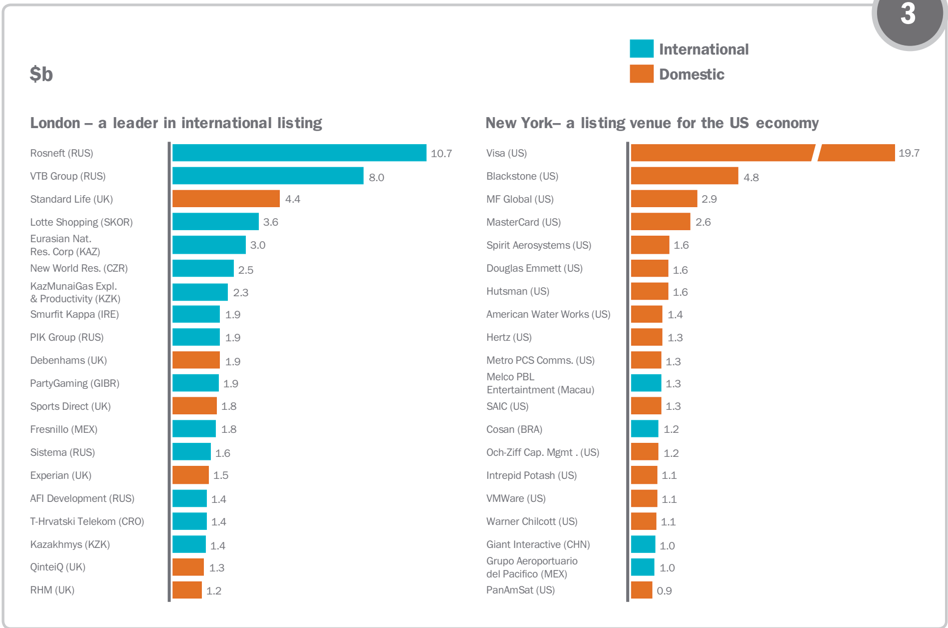
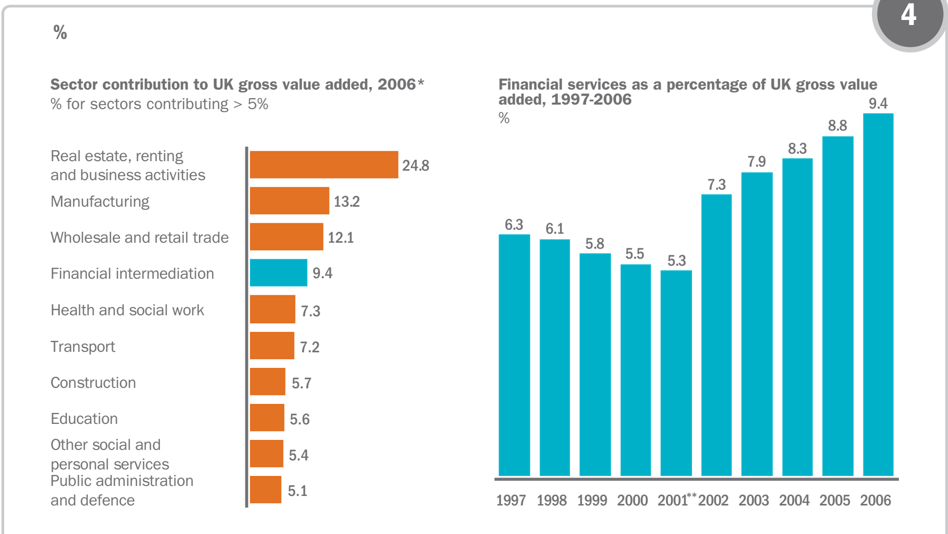


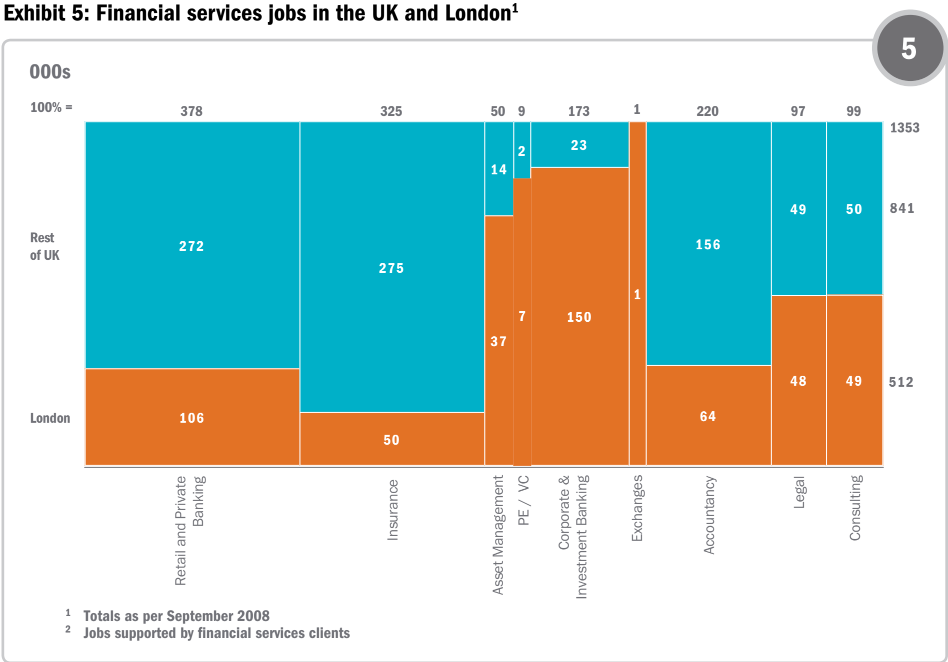
Exhibit 4: Financial services' contribution to the UK economy



* Omitted sectors (6%): Agriculture, hunting, forestry and fishing; mining and quarrying; electricity, gas and water supply; and hotels and restaurants

** The Office for National Statistics attributes a portion of the 2001-02 uptick to an increase in value-add in the insurance sector, which changed its reporting format in 2001

Exhibit 5: Financial services jobs in the UK and London[1]



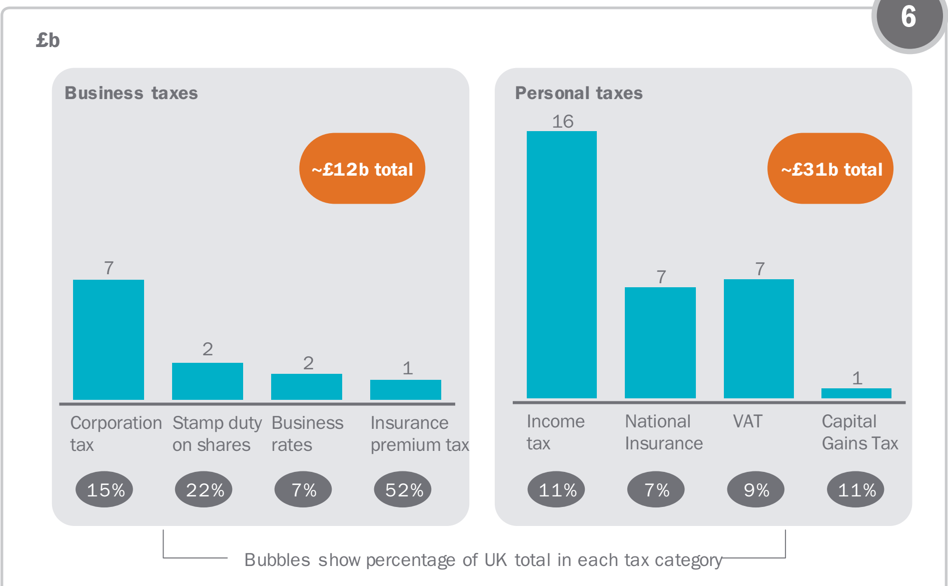
What is it worth?

What is the London financial centre's value to the capital and to the UK? The Review analysed data on the contribution of London's financial services to job creation, tax revenues and the economy overall – and found this contribution to be substantial, even after a likely contraction stemming from the financial crisis. The financial services sector's overall economic contribution has grown steadily in recent years, making up almost a tenth of the UK's gross value add in 2006. (**See Exhibit 4**).

Financial services employs some 1.3 million people in the UK – 500,000 of them in London. **Exhibit 5** shows the how these jobs are distributed: although retail banking and insurance are the largest financial services employers in the UK, employment in London is concentrated in corporate and investment banking. In addition to this direct employment, it has been estimated that the expenditure of London's financial services employees directly supports a further 400,000 to 500,000 jobs in the UK economy.

Although the crisis has already led to sharp job cuts in London, it is very likely that financial services will remain one of the capital's most important employers.

Exhibit 6: London's financial services' tax contribution, 2007/8

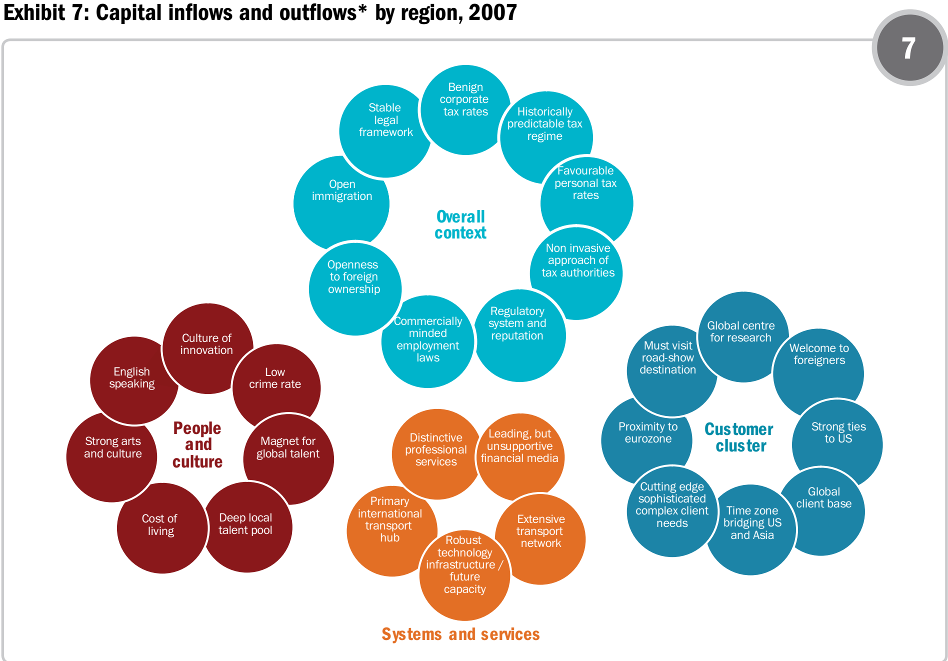


Note: Does not include unrecovered VAT or the contribution of professional service firms

The tax contribution from London's financial services is just as important. It makes up 11 percent of the UK's total income tax and 15 percent of corporation tax, delivering a total of £42bn to the UK's coffers in 2007/08 – more than the schools budget (£41bn) or NHS wage bill (£30bn) in England. **Exhibit 6** shows the sources of these tax revenues.

Another important contribution comes from the many community support and corporate social responsibility programmes run by financial services organisations and from their support for sports and the arts. Many leading arts institutions in London benefit too from private donations and support from financial services executives.

Exhibit 7: Capital inflows and outflows* by region, 2007



It is … as an international financial centre – made up of wholesale insurance, asset management, exchanges, investment banking, hedge funds, private banking and private equity – that London is truly unique.

All in all, London's financial services centre matters a great deal, to both the capital and the country. Despite their inherently cyclical nature, financial services are a large contributor of tax and employment. The UK is an undisputed leader in financial services, one of the country's few world class sectors, and has an important role to play in shaping the industry's future in the years ahead.

What drives London's financial leadership?

What then has underpinned London's leadership in international wholesale financial services – and where should government and industry focus to safeguard and strengthen it in the long term? When the Review put this question to the executives it interviewed, four main themes emerged (**See Exhibit 7**).

First, interviewees agreed that London has historically enjoyed a supportive **overall context**, including a reasonably competitive tax regime, a fair and transparent legal system, a proportionate regulatory regime and relative openness to foreign ownership and immigration.

Second, London has boasted a set of factors that have made it a powerful "**customer cluster**" – an attractive location for leading corporations and financial institutions. These include its global client base, its status as a global centre for financial research and a must-visit roadshow destination, its proximity to the Eurozone and its strong ties to the US.

Third, London's **systems and services** – including its technology infrastructure, financial media, professional services and transport network – have provided crucial support.

Fourth, London has been distinguished by its **people and culture** – including its deep local talent pool and its status as a magnet for foreign talent, its culture of innovation and creative expression and the fact that it is English speaking.

London's ascendency in international financial services has been created by an interplay of all these factors, with the implication that government and industry have a wide range of issues to manage if they are to safeguard and further build London's position. As the next chapter explains, however, London's perceived relative performance in several of these factors has been declining in recent years. This year's financial crisis compounds the threat to London's leadership.

2. London under threat

The previous chapter established that London's financial centre is a unique asset of great value to the UK and identified the inter-related factors from which London's international competitiveness is derived. The messages in this chapter are more sobering. For one thing, several of these strengths had been declining well before the 2008 financial crisis. Second, a group of competitor cities are developing increasingly aggressive and successful strategies to attract business away from London. Third, the crisis – which struck midway through this Review – may well exacerbate the threat to London's competitiveness.

The chapter:

- Assesses the deterioration in London's competitiveness in a number of areas that have been its historic strengths
- Examines the nature of the intensifying competition from other financial centres
- Makes an early assessment of the threats and opportunities that the crisis poses to London's competitiveness

Deterioration in London's historic strengths

The previous chapter set out a range of factors, identified by the executives who were interviewed, that lie behind London's success as an international financial centre. The Review subsequently analysed the current strength of each factor – through additional analysis and interviews – and concluded that London's competitiveness in several of the factors had decreased over the past one or two years, even before the current crisis **(See Exhibit 8).**

For a start, London's historically supportive **overall context** is threatened by the increasing influence of EU regulations. One executive interviewed by the Review estimated that 90 percent of regulation impacting UK financial services now originates from the EU; the UK's Financial Services Authority (FSA) itself states that around 70 percent of its policymaking efforts are driven by European initiatives. (**Exhibit 9** sets out the array of EU financial regulation that has been applied since 1999 and that is due to be implemented in the next two years). Many of the executives interviewed expressed concern that the EU policymakers shaping this regulation have had little interest in preserving London as a financial centre. In their view, the regulatory environment that historically has helped London's financial centre prosper is steadily being altered by authorities that do not have London's interests as their primary focus.

It is important to understand, however, that those consulted in the Review were not directly criticising the content of EU regulation per se. They were making the point that London could historically position itself competitively in a fragmented European regulatory context in a way that is now much more difficult with pan-European legislation. An important historic competitive advantage for London has therefore largely dissipated.

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Exhibit 8: Changing competitiveness of interplaying factors

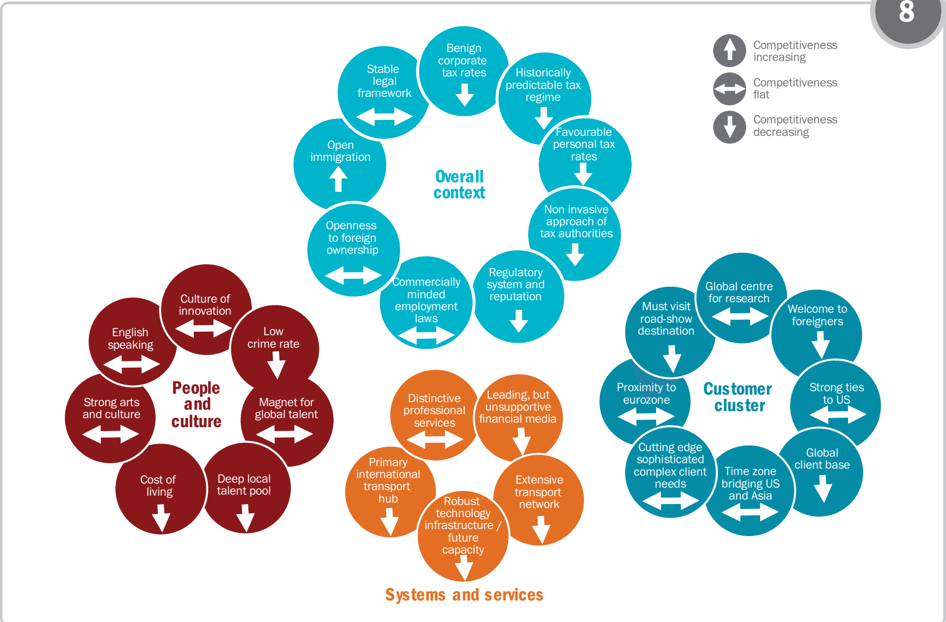
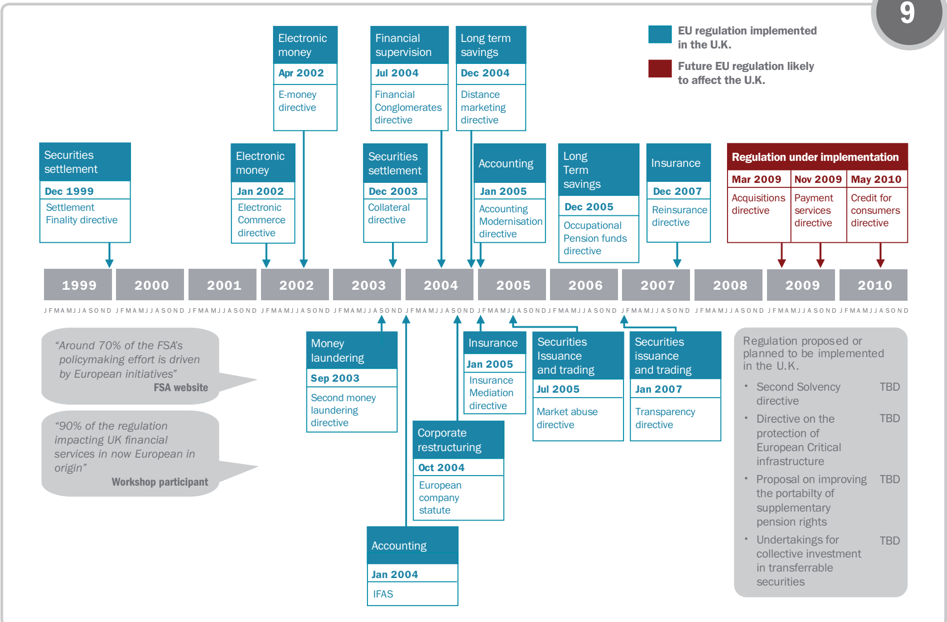


Exhibit 9: Timeline of EU financial services regulation, 1999 - 2010



The World Economic Forum cites deterioration in the tax environment as an important factor in the UK's fall in its "global competitiveness index", from second in 2006 to ninth in 2007 and to twelfth in 2008. These indicators are underlined by announcements from major companies, including Shire, Regus, Henderson and WPP, that they are relocating or considering relocating their headquarters outside the UK to save on corporate tax.

A further issue is the decline in the UK's reputation for predictable, favourable and constructively applied taxation. As an objective indicator of this deterioration, the UK dropped from first to fourth place between 2003 and 2008 in a KPMG-EVCA ranking of the tax and legal environment in EU countries. The World Economic Forum cites deterioration in the tax environment as an important factor in the UK's fall in its "global competitiveness index", from second in 2006 to ninth in 2007 and to twelfth in 2008. These indicators are underlined by announcements from major companies, including Shire, Regus, Henderson and WPP, that they are relocating or considering relocating their headquarters outside the UK to save on corporate tax.

As factors dimming the UK's tax reputation, interviewees cited the recent introduction of the £30 000 "non-dom" levy, which was perceived as having been ill conceived and poorly consulted on. They referred to the increase in the effective tax on capital gains from 10 to 18 percent as a further sign that the UK's tax environment is weakening. Interviewees cited this as a concern particularly for the private equity industry, given that private equity partners earn the majority of their income via carried interest subject to capital gains tax and given that other centres such as Switzerland have been reducing their capital gains tax expressly to lure this industry away from London.

Finally, several interviewees shared the view that across the financial services industry, the tax authorities are becoming more aggressive towards both individuals and corporates. The recent increase in the highest rate of income tax introduced in the Pre-Budget Report was considered to reinforce the view that Britain can no longer be assured to be a competitive place to base a high earning career.

It is also important to understand that the issue with both the non-dom tax levy and the recent higher rate tax increase is not so much the actual cost to individual taxpayers of the changes, i.e. £30,000 per non-dom per annum or 5 percent per taxpayer per annum on earned income over £150,000 per annum. The issue from these changes for the perceived competitiveness of London is the move from a long period when most people thought these policies were not going to change, to a sudden change, the direction of which is clearly unhelpful from a competitiveness perspective and which is perceived (whatever assurances were ultimately given to the contrary) to have the potential to be the first of a series of moves rather than a one-off event.

In return for these negative effects on perceptions of the UK's competitiveness as a place to base a career, the non-dom and higher rate tax changes will raise only minimal amounts of tax. This report seeks to make constructive recommendations to avoid such changes being introduced in future without the potential consequences for the UK's competitveness being fully understood by policymakers.

Some of the factors that historically have made London an attractive customer cluster are also under threat. In part, global economic forces are the cause: London's global client base is under threat as the share of wealth moves eastwards to fast growing economies such as India and China. Other issues are closer to home. For instance, interviewees said that the non-dom levy is likely to have made the UK's taxation system more unpredictable and uncertain in the eyes of foreign citizens and potential immigrants. London's status as a must-visit roadshow destination has been damaged by long queues and delays at Heathrow and complaints about London's congested roads. In 2007, Heathrow was ranked the worst airport in Europe for delayed flights, while the average speed of a car in London during the day was under 10mph.

Highlights of the CBI's 2008 London business survey

A third of all respondents see London's status as a world city diminishing over the next five years, compared to just 13 percent two years ago

The three major strengths of doing business in London are the capital's proximity to customers/clients, its talent pool and its communication network

75 percent of respondents are worried about rising energy costs, 38 percent fear skills shortages, and over a quarter are concerned about transport problems over the next six months

79 percent of employers are struggling to find people with the specific technical skills required for their sector

51 percent of employers rely on staff from abroad

59 percent of respondents feel that the heightened concern about crime in the capital recently, particularly knife crime, has adversely affected London's reputation as a place to work, live and do business

A third of respondents said the reliability of the Tube is good or excellent, a third are satisfied and the remaining third said reliability was less than satisfactory or poor. Quality was more of a concern, with 54 percent rating it satisfactory or poor. Over a third said that services on the Tube are improving slightly. About a third said they are staying the same and almost a third (29 percent) said they are getting worse

78 percent of respondents said the reliability of the road network is less than satisfactory or poor. **73 percent** are concerned about its quality and **61 percent** said the road network is getting worse

73 percent of respondents said it was important to build a third runway at Heathrow provided environmental standards can be met

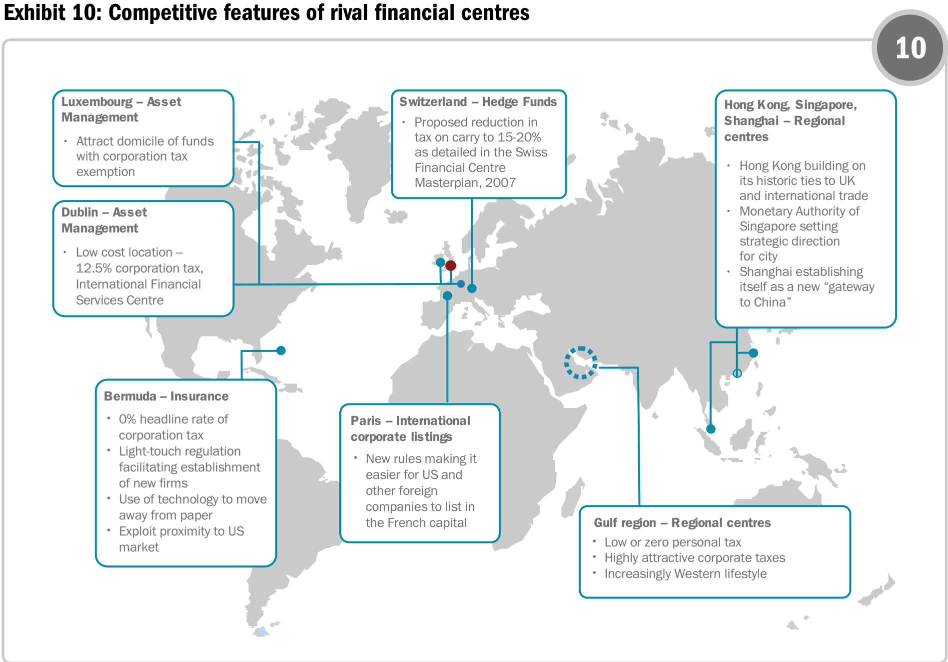
Transport is just one of the systems and services that have long underpinned London's success but is coming under strain.

Transport is just one of the systems and services that have long underpinned London's success but is coming under strain. Despite the recent go-ahead for Crossrail, the executives interviewed were concerned that improvements to London's public transport and road networks lack sufficient co-ordination and adequate long-term funding. Even though the initial problems at Terminal 5 have been overcome, interviewees were concerned that Heathrow is operating at 99 percent capacity, with no long-term solution yet in place to cater for further growth. If a third runway were not to be pursued at Heathrow, they said, it would need to be clear that there was a timely alternative that did not put London as a hub at a permanent disadvantage to its major continental European competitors. Interviewees also worried that London's electricity grid does not have sufficient capacity to support the industry's growing power requirements and that preparations for the Olympics are taking precedence in infrastructure investments.

Finally, the interviewees identified several worries about London's traditional strength in people and culture. One is that the UK's education system is not producing sufficient high-quality mathematics, finance and IT graduates to meet the financial services industry's future demand. Another is that London is regularly ranked as one of the world's most expensive cities in which to live (the most expensive, according to UBS's 2008 prices and earnings survey). Finally, crime, notably knife crime, is perceived to be on the increase in the capital. These issues damage London's magnetism for world talent.

The CBI's London business survey for 2008, published on 4 December, amplifies many of these concerns. The survey's respondents included heads of businesses across a range of industries in the capital. (**See Box: Highlights of the CBI's 2008 London business survey.**)

Exhibit 10: Competitive features of rival financial centres



Intensifying competition from other financial centres

Against the backdrop of deterioration in some of London's historic strengths, the capital faces another significant threat: mounting competition from other financial centres. New York is regrouping and a series of niche, regional and national centres are targeting different aspects of London's business across a range of industries and products. Many of these centres benefit from tax rates significantly lower than the UK's, and some are targeting particular subsectors through grants or incentives (**See Exhibit 10**).

In asset management, for example, Luxembourg has attracted funds on the basis of an exemption from corporation tax, while Dublin has profited from Ireland's 12.5 percent corporation tax. As a result, UK managers were thought to account for 38 percent of total net-asset value in Irish registered funds and 11 percent of Luxembourg funds equating to £420bn in December 2007. Similarly, in insurance, Bermuda has been able to attract firms through a combination of a 0 percent headline rate of corporation tax, an attractive regulatory regime, efficient technology and proximity to the US market. Bermuda has cost London an estimated £450 million in taxes and 700 jobs since 2000.

Exhibit 11: London's promotional bodies

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London First	Think London	Mayor of London	City of London	International Financial Services London, IFSL
Funding: Members and LDA grants "London First works on behalf of the capital's leading employers to make London the best city in the world in which to do business"	**Funding: LondonFirst / LDA** "Think London is the official foreign direct investment agency for London"	**Funding: Council Tax** "Aims to provide strategic direction for the future of London"	**Funding: Tenants** "Committed to serving the needs of international business and maintaining the environment in which organisations and companies from all over the world can play their part in financing global trade and development"	**Funding: Members** "The only independent organisation representing the whole UK financial services industry. We promote the industry around the world, influence trade policy and publish definitive research on the sector"

London Development Agency	CBI	UK Trade & Investment	London Stock Exchange	FSA
Funding: HMG "Responsible for driving London's sustainable economic growth and ensure London remains a global success story. We drive forward equality, health and work along 4 themes: marketing London, encouraging business, places & infrastructure, supporting people"	**Funding: Members** "The CBI helps create and sustain the conditions in which businesses in the UK can compete and prosper for the benefit of all. We are the premier lobbying organisation for UK business on national and international issues"	**Funding: HMG** "We work with UK-based businesses to ensure their success in international markets. We also encourage the best overseas companies to look to the UK as their global partner of choice"	**Funding: Private** "The London Stock Exchange is at the heart of the global financial market and is home to some of the largest, most successful and dynamic companies in the world"	**Funding: Industry levy on authorised firms** "The FSA are required to have regard to the international character of financial services and markets and the desirability of maintaining the competitive position of the UK"

In the hedge fund sector, Switzerland and its favourable tax environment pose a very strong and growing threat, particularly after the Lehman collapse and the UK's non-dom and higher rate tax changes. Switzerland also presents London with mounting competition in wholesale finance generally, as does Paris.

The steady shift in economic power towards emerging markets, particularly India, China and the Middle East, is compounding these threats. Wealth is being dispersed away from traditional financial centres, heightening the competition that London faces from regional centres such as Dubai, Shanghai and Singapore.

The competition from other centres exposes the fragmented nature of London's efforts to protect and promote its own financial centre. An array of private and governmental institutions work at this task with considerable energy – the City of London Corporation stands out as one example. (**See Exhibit 11**). Yet these groups find it difficult to achieve the full impact that one overarching, properly resourced body might deliver.

Case study of Singapore's long-term success

Singapore launched a reform of its financial centre in 1997 with an ambitious aim – turning a local financial centre into a regionally significant player. Today, Singapore is the fifth largest foreign exchange centre in the world and its asset managers have some £500bn of assets on their books. Singapore has also built up the largest stock market in Southeast Asia with a substantial proportion of international listings.

These achievements were led by a central government body, the Monetary Authority of Singapore (MAS). The MAS is mandated with the task of "developing Singapore as an international financial centre", alongside its other responsibilities in regulation, currency issuance and central banking. It led the 1997 reform efforts with some exceptionally bold initiatives, such as opening its banking system to foreign ownership, initiating a phase of banking consolidation and merging and restructuring its securities and futures exchanges.

These initiatives depend on talented leadership. The MAS's efforts are led by Singapore's elite civil service, selected through a rigorously meritocratic promotion system, and the most senior of whom are paid above $1m a year.

The centre continues to innovate and develop aggressively.

By contrast, London's newer rivals are typically more strategic, co-ordinated and assertive in their promotion efforts. Consider the Dubai International Financial Centre as an example. It has set itself the aim of "developing the same stature as New York, London and Hong Kong", and has strong government support (including a 0 percent tax rate on income and profits) and talented leadership (its CEO is a former CEO and Chairman of the Hong Kong and Shanghai Banking Corporation). In just four years, Dubai has licensed more than 750 financial services companies.

Singapore is another powerful example: in the ten years since it launched a co-ordinated strategy to grow its financial centre, it has captured huge swathes of the asset management and banking industries to become a regional leader (**See Box: Case study of Singapore's long-term success**).

Impact of the financial crisis

The Review has also responded to market developments over the course of its work, conducting further analysis to take an early view on how the crisis might impact on London's long-term competitiveness.

> … London has an imperative to position itself, beyond the crisis, as the best regulated international financial centre.

Although the full impact of the crisis is as yet unknown, continued and prolonged recession and volatility can be expected in global financial markets. It is likely that the crisis will lead to significant changes in investment banking business models and further consolidation of banks in their home markets; it may also prompt major international companies to consider retrenching back to home markets. All three developments would put London's revenue at risk. A further concern is that the reduced number of jobs in the capital will harm London's status as a magnet for global talent – just as centres in developing markets could be becoming more attractive to skilled financial services employees.

The Review identified four main threats to London's financial centre emerging from the crisis, each offering some corollary opportunities.

The first is the series of developments including Northern Rock, the Lehman Brothers collapse (and its subsequent slow and uncertain resolution) and the Icelandic bank collapses which have struck at the heart of confidence in doing business in London. The result of these events is that London can no longer take it for granted that it will be seen as a trusted place to do business underpinned by a world-revered financial regulatory regime and an open, transparent and fair legal system.

The second is the likelihood of **new regulation** – with an impact over and above the pre-crisis trajectory of EU-driven regulation, discussed above. There is widespread agreement amongst political and industry leaders on both sides of the Atlantic that regulatory reform is required, although policymakers' thinking is still at its early stages. One threat is that ill-conceived regulation could be rushed through. Another is that new regulation overcompensates for possible gaps in pre-crisis regulation, putting in place unduly restrictive rules which stifle enterprise. A third is that policymakers in various countries succumb to pressure for "protectionist" regulation of international markets. Finally, there is a risk that rising unemployment will lead to greater limits on immigration – a cause for concern given the London financial centre's heavy reliance on foreign workers.

London will need to work hard to avoid such outcomes and must act as a leader in helping to shape an effective regulatory climate – in the EU and globally. Indeed, London has an imperative to position itself, beyond the crisis, as the best regulated international financial centre.

The third threat to London from the crisis is of continuing **negative publicity** for the City, with the public holding the industry responsible for the crisis itself, due to perceived greed and excessive risk-taking. The risk is that public perceptions of financial institutions remain poor – amplified by an increasingly hostile media – and that customers react negatively and politicians are encouraged to react disproportionately on regulation. With this risk in mind, it will be important for London to help balance public understanding of the crisis. Where appropriate, the industry must of course acknowledge over leverage and weaknesses in risk management and governance. On the other hand, London will need to emphasise the dangers that regulatory overreach would pose in a competitive world as the global industry gets back on its feet – and as the UK restores its economic health. Much will depend on how other financial centres act on new regulation; this comparative position will need to be monitored carefully.

Finally, there is the threat that **overseas banks retrench** and consolidate further, refocusing their operations on their domestic markets. The risks from such a development are that the international banking business recedes, major overseas players scale back their international operations and London is forced to rely more heavily on the UK domestic market.

3. How London can win in a changing world

The most important aspect of the Review's work was to develop recommendations on the actions that political and industry leaders can take to strengthen the long-term competitiveness of London's financial centre. This chapter contains those recommendations.

The Review assessed a range of proposals and identified five major recommendations for London's – and the UK's – leaders. These include:

1. Rebuilding the UK's reputation for leading global financial regulation
2. Creating a single powerful board to promote London as a financial centre
3. Boosting infrastructure, including data centres, power and transport
4. Ensuring London remains the location of choice for professionals starting and progressing international financial services careers
5. Improving the competitiveness and predictability of the UK's tax regime

This chapter discusses each initiative in turn.

Rebuilding the UK's reputation for leading global financial regulation

In the wake of the financial crisis, one overarching development is needed to protect the competitiveness of London's financial centre: rebuilding the UK's reputation for leading, global financial regulation and with it restoring trust in "dealing in London". The responsibility is shared: the financial services industry must recognise its responsibility to support the regulatory authorities in this task. Much good work is already done by, for example, the Financial Services Global Competitiveness Group involving the City of London Corporation, HM Treasury and the FSA.

The Review developed several recommendations for steps that industry and government should take.

The industry must support the FSA's planned move from risk-based supervision to a more intense supervisory model, building on the enhanced supervisory programme recommended after the FSA's review of its supervisory failings on Northern Rock. Further plans will be published shortly in the Turner Review. The industry must, however, accept the somewhat higher costs this enhanced supervision will inevitably involve in order to restore customer confidence in the regulatory regime. Principle-based regulation increasingly requires supervisors to make judgments based on a good understanding of their supervised entities' businesses. The industry must therefore support the FSA in achieving the upgrade in talent it seeks by supporting supervisor recruitment and training. Specifically, as an initial step the industry should double the number of secondees it supports over the next 12 months with more thereafter and more proactively provide "grey panthers" and subject expertise for enforcement cases when called on by the FSA. This should be achieved by the banks formally mandating the banking trade associations to achieve these objectives collaboratively.

The industry must also work closely with the FSA as it seeks to develop new guidelines on remuneration policies to address both widespread misunderstandings and justified concerns amongst shareholders, customers and the public about banking compensation.

The industry must also do all it can to support the creation of a new global regulatory framework. One of the global treaty-based organisations (whether the IMF or a new body) will likely be mandated as a result of the current G20 discussions to provide better co-ordinated supervision of the world's largest financial services firms and this should be welcomed. The new policy framework will also need to address the flaws which have been exposed by recent failures in Europe's "home host" model, which has contributed to the perception of London's regulatory regime being damaged. The industry should provide senior engagement and expert resources to support the detailed policy development that the FSA and HM Treasury need to undertake.

In the wake of the financial crisis, one overarching development is needed to protect the competitiveness of London's financial centre: rebuilding the UK's reputation for leading, global financial regulation and with it restoring trust in "dealing in London".

The Government must urgently review the UK's administration laws to restore trust in London-based financial services subsidiaries of overseas firms. The process the Lehman Brothers London subsidiary administrators have had to go through – and the fact that they carry personal liability – is inconsistent with a rapid release of assets and settlements to creditors, and therefore stands in the way of rapid resolution of the insolvency. This has been a major problem for many market participants who had assets or cash with Lehman, as global firms' UK operations fared materially worse in relation to Lehman's insolvency than in other financial centres. It also risks prompting the prime broking business and ultimately the hedge fund community to move rapidly away from London – a very serious threat given the high proportion of investment banking revenues generated directly and indirectly by hedge funds.

Recently mooted changes to the Banking Bill will start to address this problem. A more comprehensive overhaul of the UK's insolvency laws applied to financial services firms will however take some time. In the meantime, the industry is working rapidly and constructively together with the FSA to establish short-term routes to rebuilding confidence in client asset and money segregation procedures. The industry should also work to prepare its own plans to co-operate with competitor firms and the authorities to deal with any failure of a systemically significant counterparty, putting the interests of wider financial stability ahead of banks' own positions.

The combination of these steps should over time restore confidence amongst clients in doing business in London.

The Government must support the FSA in addressing the historically low prosecution rates in relation to insider dealing, by granting whistleblowers statutory immunity. "Credible deterrence" to insider dealing must be established and the frequency of share price moves in advance of announcements drastically reduced. Firms must continue to co-operate proactively with the FSA to address market abuse.

The Bank of England will shortly acquire new responsibilities in relation to failing bank resolution as the Banking Bill becomes law. The Bank, it is hoped, will enjoy many years of "peacetime" when its role of resolving failing banks will not be required. In crisis periods, it may need to supplement its permanent staff with potentially substantial numbers of industry secondees. The financial services industry must accept its responsibility to provide such resource speedily when called upon by the Bank and should prepare for this eventuality in 'peacetime' by working collaboratively on a project to identify a pool of potential secondees.

An annual survey to benchmark UK regulation

The nature of the regulatory regime is clearly a major consideration for financial services firms, issuers and investors when deciding between alternative financial centres as to where to base their operations.

An annual survey of global and local regulatory developments should be undertaken by the International Centre for Financial Regulation (ICFR) along three dimensions: industry, geography, and interested parties. Industries covered would include asset management, investment banking, retail banking, insurance, exchanges, hedge funds and private equity. Geography would include major financial centres, offshore financial centres, and emerging financial centres. Interested parties would include investors, issuers and intermediaries, since each will have a different perspective. In addition, it would be important to survey new developments in regulation each year so that the survey could take into account new players, techniques or ideas. The survey would seek to ensure that factors putting London at a potential competitive disadvantage were promptly highlighted.

Creating a single powerful board to promote London as a financial centre

In Chapter 2, the intensifying competition from other financial centres was identified as a significant threat to London's leadership position – and London's own promotion efforts were shown to be less co-ordinated than those of some of its nimbler rivals.

The Review therefore recommends that London form a single powerful, properly resourced financial services representation board under the leadership of the City of London Corporation, bringing together the financial services elements of existing overlapping groups. This body should be tasked with promoting London's financial services sector overseas, anticipating strategically important trends and highlighting to the domestic audience the industry's contribution to the UK – both financially and in terms of corporate social responsibility. The core activities of this board would include:

- **International brand development.** The board would design a brand and marketing strategy for London's financial services, attracting leading financial institutions to London through international promotion and practical support. It would develop a plan to promote listings in London independent of the London Stock Exchange's efforts, given the growing number of potential listing venues. Further, it would aspire to grow London's penetration amongst leading non-domestic financial institutions. Every large international bank, asset manager, insurance company, hedge fund, sovereign wealth fund and private equity firm should be systematically targeted to locate in London.

Exhibit 12: Envisaged mandate of London's Financial Services Promotion Board

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MAJOR ACTIVITIES

International brand development
- Attract leading financial institutions to London through out-reach and practical support
- Define London plan for growing listings

Strategic planning
- Engage top leaders to develop positions on key policy and regulatory matters and sector-level priorities
- Roll out long-term plan, annual goals and product plans for emerging segments
- Develop data, e.g., annual benchmark of UK regulation

Domestic image and community relations
- Promote the sector's contribution to the UK
- Lead community initiatives in the UK

PEOPLE AND FUNDING

Funding
- Fund initiative jointly between industry and government bodies, potentially through streamlining existing groups

Leadership
- Create new board containing top leaders from banks, insurers, asset managers etc
- Appoint industry chairman of high calibre to oversee the agency
- Hire leadership team with breadth of commercial and government experience

ASPIRATIONS FOR 2015?

Strategic planning
- Provide visible, credible leadership
- Create plans that shape the policy debate
- Help make London the global leader in new segments

International brand development
- Increase share of leading financial institutions in London

Domestic contribution
- Take community initiatives to next level, including university sponsorships
- Substantially improve public image of the sector

> This body should be tasked with promoting London's financial services sector overseas, anticipating strategically important trends and highlighting to the domestic audience the industry's contribution to the UK – both financially and in terms of corporate social responsibility.

- **Policy and strategic planning.** The board would engage top leaders to develop positions on key policy and regulatory matters and sector-level perspectives on key trends, challenges and emerging product developments, annually providing an independent review of the UK's regulatory regime. It should annually commission the International Centre for Financial Regulation to benchmark UK regulation against that in place elsewhere in the world (**See Box: An annual survey to benchmark UK regulation**). It would ensure plans were in place to keep London the global leader in emerging segments and new products.

- **Domestic image and community relations.** The board would be responsible for substantially improving the perception of the financial sector in the UK. As one way to seek to redress the negative sentiment towards the sector, it would support financial services companies in highlighting the sector's substantial corporate social responsibility, arts and sports contribution to the community.

The full mandate of the proposed board is contained in **Exhibit 12**.

It will be essential to endow the new board with strong leadership, including board level leaders from major sector players. A chairman of top industry calibre should be appointed to oversee the board, supported by a leadership team with broad commercial and Government experience. Creating this board will require a co-ordinated effort between the City of London Corporation, the Mayor's office and many of the bodies that have international financial services as part of their remit today.

Some interviewees pointed to power challenges already facing their businesses. On hot summer days in 2008, for example, one major institution had to switch off the air conditioning for its offices to ensure that its server rooms were left with sufficient power.

Boosting infrastructure

In Chapter 2, the report noted that London's increasing strained infrastructure is a significant threat to the capital's competitiveness as a financial centre. Although the recent go-ahead for Crossrail is a promising development, more needs to be done to ensure that London's strained public power, transport and data infrastructure does not put it at competitive disadvantage. The Review recommends that the Greater London Authority (GLA) co-ordinate a concerted effort to provide infrastructure support to the financial services industry, working closely with the City of London Corporation where appropriate.

As a first step, the GLA should set up a "financial services infrastructure group" which would study and plan for the long-term infrastructure needs of the industry, with particular focus on data centres and the power needed to support them. The group would be tasked with identifying and resolving conflicts between London's different priorities, including financial services and the Olympics; co-ordinating the large number of private and public stakeholders involved in infrastructure plans; and acting as bridge between industry, infrastructure providers and local Government.

It is worth pausing to consider why data centre capacity, a priority issue for the proposed GLA group to tackle, is such an important concern for the industry. A significant share of trading today is electronic and does not conform to the traditional image of a broker on the phone talking to customers and then executing a trade on another phone or a computer. Rather, it is by electronic messaging that much trading is now effected – and speed is of the essence. As a result, the financial services industry's data processing and "latency" demands are large and fast-growing. Because data processing is energy-intensive, the industry also has rapidly growing electric power needs. A large data centre may require anywhere from 50 to 80 MW of power – the equivalent to that required for a small town. For a more detailed exploration of these issues, see Appendix 2.

For a number of reasons London is already struggling to meet these demands. Electric power in the capital is costly and constrained in availability, space is both expensive and in short supply and most buildings in the financial districts are not designed to house data centres. This is compounded by a planning challenge: to secure the power supply for a data centre can take five years from the initial planning request.

A further hurdle is the requirement that new data centres conform to green technology that enables sites to re-use the heat created by large numbers of co-located computers. Sites in London's financial districts are often not suitable for applying such technology.

The proposed new GLA group would provide leadership, support and assistance to an industry initiative to co-locate key execution venues and market participants within a common data centre or campus environment in London. This would greatly reduce the IT infrastructure costs and difficulties of connecting multiple trading partners and remove the need for the current latency "arms race". It would also give London-based firms significant cost and scale advantages over other market centres both within Europe and further afield. London would be seen clearly as the leading centre for electronic trading, with consequential benefits for other activities such as listings, technology and software development. This campus would also provide opportunities to co-locate other functions – such as middle office – alongside the data centre, with further efficiency savings. The latest energy efficient designs would make it possible for the overall power consumed to be lower than the current dispersed situation and there may even be scope to re-use the waste heat locally.

This issue is highly topical since there are several large firms who have individual data centre build needs in the next two years, all of whom would currently be making significant uncoordinated capital expenditure. An initiative supported by the GLA would therefore be timely from an industry perspective, as well as having the potential to add to London's competitive advantage. The group could also take specific steps to help meet the industry's growing electric power demand, which is driven largely by the cooling needs of data and server centres. This demand may accelerate if new regulation increases the record keeping and reporting requirements of financial services institutions. It should be noted that EDF Networks does have a schedule for network upgrades and the National Grid regularly updates its seven year statement looking into future reserve margins. However, several of the executives interviewed were concerned that the delivery dates of these upgrades would post-date their data centres' additional power needs. Some interviewees pointed to power challenges already facing their businesses. On hot summer days in 2008, for example, one major institution had to switch off the air conditioning for its offices to ensure that its server rooms were left with sufficient power.

In the short term, individual firms or exchanges may reject the idea of a co-located exchange and data centre as removing competitive advantage. Firms will hopefully recognise that these advantages will be short-lived and that safeguarding London as the centre of European trading is ultimately the greater prize.

Transport, which many interviewees cited as an impediment to London's competitiveness, is a further infrastructure issue which the new GLA group would help to solve. The group could assist by assessing what the impact of delays in envisaged new transport links such as Crossrail would be on commuting into the City of London and Canary Wharf. It might also help source private funding for critical projects.

The recent events in Mumbai demonstrate the ongoing threat of terrorist attacks around the world. The GLA must ensure that London's businesses make the necessary preparations in business continuity terms for the possibility of periodic attacks, and that they work effectively together to support the Security Services in deterring potential terrorist activity in advance. The FSA has done good work in raising the financial services sector's awareness of contingency planning issues and the GLA should undertake a wider benchmarking exercise to assess the business preparedness of particularly critical infrastructure. Further incidents are likely at some point. London will be judged by its apparent preparedness and the degree of co-ordination in its responses. The GLA would need to work closely with the City of London Corporation on this initiative and not duplicate work already underway in the London Regional Resilience Forum.

Making London the location of choice for financial services careers

Although London's financial services industry has already experienced significant job losses in the wake of the crisis, the Review concluded that attracting, retaining and developing talent would remain an important long-term factor in London's international competitiveness. As a priority action, the Review therefore proposes a programme to keep London the location of choice for professionals starting and wishing to progress their international financial services careers, led by the Chancellor's High Level Group and involving the Financial Services Skills Council and the London Skills and Employment Board. This would build on existing initiatives led by the City of London Corporation such as the City Programme, which brings practitioners, officials and regulators from other EU states to spend time in London.

There are three possible examples of specific initiatives that the programme could drive.

First, it should seek to support London in becoming the centre for academic excellence in addressing the many topical issues facing the financial services sector. These include, for example, the development of new regulation; risk management; and issues surrounding sovereign wealth funds and how they should manage their affairs. London is surely the natural place to lead consideration of the emerging issues facing the sector. Yet today the industry's relationships with and financial support for London's business schools are weaker than those of competing financial centres.

Second, it could strengthen London as a magnet for overseas talent. The world is witnessing the emergence of significant new talent pools and one powerful way for London to tap into them could be to bring top Indian and Chinese universities or business schools to London, in the same way that Singapore attracted INSEAD and the Chicago GSB (care would need to be taken, however, to ensure this was not just at the cost of cannibalising important revenue streams for London's existing universities). The initiative should consider ramping up support for schemes to provide scholarship assistance for people coming to London, matching the incentives they are offered by other competitive centres. Existing schemes like the Chevening Scholarships have been declining from an already low level compared to other financial centres.

This initiative could also help develop a long-term immigration system better oriented towards financial services, based on international benchmarks. Recent changes in immigration law have gone in the wrong direction, making it harder for many MBA graduates to live and work in the UK. The previous policy, through which Tier One MBA graduates automatically qualified for Highly Skilled Migrant status, has been revised and MBAs now need to apply via a point system. This change has removed one of the relative competitive advantages of London MBA programmes against their US counterparts.

A third initiative would be to help universities develop top quality facilities. Many leading overseas schools provide – and international students expect – the highest quality academic, residential and extra-curricular facilities. London universities struggle to replicate these: their endowments are low by comparison with those of US universities in particular and, apart from City University, they do not benefit from capital or revenue funding from either the GLA or the Corporation. Industry and government should work together to explore opportunities to provide local universities with endowments and capital funding, as well as operational support – for example, scoping the use of the Olympics legacy site and supporting appropriate planning applications more proactively.

The programme could shape an initiative to support universities in developing teaching and research functions. In the US and continental Europe, financial services institutions often have close links with universities; by contrast, the London School of Economics' and London Business School's largest funding partners are all foreign-based. There is a variety of ways in which industry could help, including providing industry specialists to teach certain courses; helping design courses with increased vocational relevance; funding professorships or research; and contributing thinking on emerging issues. Both the authorities and industry would need to support the programme with funding.

Improving the competitiveness and predictability of the UK's tax regime

As Chapter 2 described, most of the industry executives interviewed for the Review believed that the UK's reputation for predictable, competitive and constructively applied taxation was deteriorating – thus threatening London's position as a leading global financial centre. Work is of course already underway on the Professional Services Global Competitiveness Group, involving the City of London Corporation on tax-related issues and on improving dialogue and consultation between industry and HM Revenue & Customs – and the Financial Services Tax Forum will also contribute.

However, the Review's analysis of this issue has led it to develop specific proposals for tax reform for consideration by HM Treasury. Some of these proposals, if implemented, could involve a short-term cost to the Exchequer. The authors recognise that the public finances are under pressure. The proposals will take some time to develop and can only be implemented over time as overall budget constraints permit.

However, the Review has also established that the required analysis and data does not currently exist to enable an informed assessment of the short-term cost versus medium-term gain that the proposals would create. The authors believe that the proposals in this section would, if implemented, have the effect of attracting more banks and companies to base their headquarters or holding companies in London and create significant new employment. This in turn should create a "cluster effect" of additional tax revenue (including corporation tax, PAYE, NIC, VAT and other taxes) which could, over time, more than pay for any short-term loss in corporation tax. One of the immediate workstreams for the Chancellor's High Level Group should therefore be to commission an independent study to examine how predictable, competitive and constructively applied the UK's tax regime is by international standards and to test the likely short-term costs and medium-term benefits of the Review's specific proposals. (**See Box page 34: Proposal for annual benchmarking of London's tax competitiveness**).

The Review has three main proposals on strengthening the tax regime, each outlined below and described in greater detail in Appendix 3:

- Improve the process of introducing new tax policy
- Use the tax system to reinforce the UK as the most attractive geographic location for companies to base their headquarters or regional holding companies
- Set out a strategic policy for corporation tax, to demonstrate the UK's intention to remain competitive in an increasingly challenging global tax environment

Improve the process of introducing new tax policy

The Review recommends that a standing committee of experts be formed by HM Treasury and HM Revenue & Customs, including senior representatives from the tax profession and senior business executives, with the mandate to review proposed policy changes and legislation on a strictly confidential basis, before they are put out for wider consultation. This would ensure that those so released were adequately thought out and drafted, and the impact on business and competitiveness had been carefully considered. The standing committee would not in any way remove the need for subsequent full consultation, but should reduce the risk of proposals having to be totally redrafted or withdrawn – or of unnecessary alarm arising from potential implications that Government may not have considered. The standing committee would have a legal obligation of secrecy, breach of which would be a criminal offence.

Use the tax system to reinforce the UK as the most attractive European headquarters location

Currently, if a company is tax resident in the UK it is subject to UK tax on all its profits wherever earned. This means that foreign branches of a UK company are subject to UK tax on their profits and dividends repatriated from foreign subsidiaries are taxed in the UK. These rules act as a deterrent to groups locating their parent company, or possibly a regional holding company, in the UK. In a globalised economy where capital may well be provided by non-UK investors and invested in activity outside the UK, there is a very strong case that the UK should move to a "territorial" base of taxation which means it would only tax profits earned in the UK.

As part of the Pre-Budget Report delivered on Monday 24 November, the Government announced that there would indeed be a "move towards a territorial approach to taxing foreign subsidiaries". This is very welcome. The Review recommends, however, a more far-reaching set of changes in tax policy:

- Foreign dividends should not be taxed when repatriated to the UK. It was announced in the Pre-Budget Report that a dividend exemption system will be introduced in Finance Bill 2009. This is a welcome step towards the "territorial" approach.

Proposal for annual benchmarking of London's tax competitiveness

This annual study would assess London's tax competitiveness relative to rival locations for financial services firms and multinationals' headquarters. It should be carried out by Oxford University's independent and highly regarded International Centre for Taxation.

The report would focus primarily on corporation tax, both in terms of headline tax rates but also factors determining the tax base. It would also consider how tax policy is formulated, how reform is undertaken and how tax is administered.

The International Centre for Taxation would develop two types of effective tax rates as indicators for tax policy benchmarking: for the financial services industry and for multinationals' headquarters. It would also analyse the role of other taxes that may have a significant impact on location choice for these two groups, and the stability and administration of the tax regimes in question.

Further details of this proposal can be found in Appendix 3.

- **Exempt foreign branches.** Where a UK company operates through a foreign branch it will be automatically taxed in the UK on its foreign profits (subject to double tax relief) and, in most cases, is able to deduct losses made overseas against its UK taxable profits. It is proposed that branches should also be exempt from UK tax. This would mean that there is no distortion between the decision to set up a foreign branch or a foreign subsidiary as the profits from both types of entity would not be subject to UK tax. However, simply exempting branch profits would cause a considerable cost to companies that currently are able to obtain benefit for foreign branch losses. It is therefore proposed that companies would be able to deduct foreign losses in the same way as at present. When the branch becomes profitable, the loss relief given would be clawed back, but any excess profit would not be taxable.

- **Amend the Controlled Foreign Company Rules so that they only target profits actually diverted from the UK.** Where these anti-avoidance rules apply, the profits for a foreign company are attributed to the UK parent and immediately taxed in the parent's hands. In particular, where one foreign subsidiary lends money to another or licences intellectual property to another the profits will often be taxed in the UK. There is a concern amongst business that the rules prevent commercial structuring of overseas activities and put UK-based multi nationals at a competitive disadvantage. The Pre-Budget Report announced that Government will continue to examine options to reform the rules so that they achieve the objective of "taxing profits diverted from the UK" and not "profits which are genuinely earned in overseas subsidiaries". Again this is a welcome announcement. However, it appears that it is likely to take at least two years to achieve. The Review recommends that this process be expedited, potentially by using the expert tax standing committee proposed above. Further, there should be a clear Governmental statement that, in the interim period, the existing rules will be applied in a way which reflects this intended move to territorial taxation.

- **Clarify the definition of residence for companies.** Under current rules, a company is UK tax resident if it is incorporated in the UK or if its so-called "central management and control" is in the UK. In practical terms, if the board of directors meets in the UK the company is usually UK resident. There are many cases where foreign enterprises, particularly new and fast growing companies, wish to locate their key executives in the UK to access the financial and business centre of London. The central management control test results in such companies having to be very careful about who is employed in the UK and about what activity takes place in the UK. Often directors are instructed not to take certain decisions in the UK or to telephone into board meetings from the UK. It is proposed that the central management and control test should be clarified, by guidance or by statute, to make it clear that such activities do not make a company UK resident.

It is recognised that these proposed changes carry the risk of prompting companies to divert profits artificially from the UK and that anti-avoidance rules would need to be introduced to prevent this. Industry would need to co-operate responsibly to ensure the design of these rules were effective.

Use corporation tax policy to make the UK competitive

Corporation tax is a cost of operating a business and with statutory rates coming down globally, the UK needs to act to maintain its competitiveness. It would send out a strong signal in the business community if there was a policy of keeping the statutory rate in, for example, the lowest decile of the leading financial centres in the EU. An example of an even more ambitious public commitment is the policy adopted by the Canadian government in 2007, which undertook to "give Canada the lowest overall tax rate on new business investment in the Group of Seven (G7) by 2011 and the lowest statutory tax rate in the G7 by 2012".

The Review very much endorses the conclusions of the fourth meeting of the OECD Forum on Tax Administration, summarised in the Cape Town Communique: "Revenue bodies can achieve a more effective and efficient relationship in their dealings with taxpayers and tax intermediaries if their actions are based on the following attributes: understanding based on commercial awareness, impartiality, proportionality, openness and responsiveness. These attributes are fundamental for any revenue body and should underpin all their dealings with taxpayers". Participants in the review felt that where HMRC had adopted this approach and companies had responded, enhanced relationships had developed to the benefit of both HMRC and the company concerned - with greater certainty, less extensive audits and lower compliance costs - and that this should be the model to achieve more widespread improved tax administration going forward.

4. Leading the way for London

The five initiatives proposed in Chapter 3 will take considerable energy and co-ordination to implement. They will require careful phasing. The leaders who drive them – including industry executives, the Mayor, the City of London Corporation, the Chancellor's High Level Group, HM Treasury and the Government more broadly – will each need to be clear about the roles required of them and commit to seeing the initiatives through to completion.

This chapter:

- Suggests how each of the proposed initiatives could be phased, identifying action required immediately, steps to be taken over the coming 1-2 years and longer-term actions
- Identifies the logical leadership roles which the Mayor, the City of London Corporation, the Government and industry could play in implementing the initiatives

Phasing of initiatives

It is important that the proposed initiatives, when implemented, create a rapid and sustained positive impact on London's competitive position. The Review therefore identified three implementation phases for the initiatives – 2009, the next one to two years, and beyond 2010. **Exhibit 13** sets out the major implementation steps for each of these phases.

Steps for implementation immediately and in the coming year include providing input from industry leaders into the post-crisis regulatory response, as part of the effort to rebuild the UK's reputation for leading financial regulation. Other immediate steps involve engaging the important stakeholders – both government bodies and private institutions – on the Review's proposals to establish a single promotion board, improve the tax regime and make London the location of choice for financial services careers. Further, the proposed GLA "financial services infrastructure" group should be put in place during 2009.

Substantive actions are proposed for implementation over the next one to two years. In rebuilding financial regulation, these include contributing industry resources – not least a substantial budget – to supporting regulatory reforms and designing the enhanced secondment programme between industry and regulators. The new London financial services promotion board should be up and running, with a budget and funding model agreed, a governing Board in place and a chairman and executive team appointed. Meaningful progress should have been made on the tax front too, with a tax benchmarking review commissioned and a standing committee appointed. The current uncertainties about foreign tax issues will have been examined and debated and cost-benefit analysis developed.

It is important that the proposed initiatives, when implemented, create a rapid and sustained positive impact on London's competitive position.

Exhibit 13: Phasing of proposed initiatives

	2009	Next 1-2 years	2 years +
1 Regulation	• Provide senior industry input to regulatory response to crisis	• Contribute resources to support regulatory reforms, including substantial budget • Design talent exchange programme between industry and regulators	• Continue to contribute to regulatory development, including validation of new legislation as the market evolves • Achieve fully operational talent exchange programme between industry and regulators
2 Financial services board	• Engage stakeholders, e.g., Corporation of London, IFSL, GLA	• Agree budget/funding model • Appoint Board and define high level organisational structure • Appoint Chair and Executive team	• Fully operational body
3 Boosting infrastructure	• Set-up "financial services infrastructure" group in GLA	• Develop plans for new data centre farm and trading hub	• Finalise plans and investment for new European led data hub and data centre farm
4 Careers location	• Engage stakeholders, especially HLG, FSSC, London skills and Employment Panel	• Establish high end skills mandate within HLG • Publish first implementation plan for talent programme • Identify priority opportunities to support university facilities, research and teaching • Reach out to Indian and Chinese campuses that could come to London • Identify developing country MBAs for Tier One list	• Bring 2-3 Indian and Chinese campuses to London • Establish support programmes for university facilities, research and teaching
5 Tax regime	• Discuss proposals with HMT • Establish new consultation panel for tax changes	• Address uncertainty on foreign tax issues • Establish tax benchmarking panel	• HMT statement on competitiveness of tax rates

Turning to the initiative to boost infrastructure, major actions over the next one to two years include developing plans for new data centre capacity and a co-located trading hub. Finally, tangible progress should be made in strengthening London as a location for financial services careers. Actions include the Chancellor's High Level Group publishing a plan for the proposed talent programme working alongside the FSSC and the London Skills and Employment Board; identifying priority opportunities to support university facilities, research and teaching; and securing Indian and Chinese campuses that could locate in London.

Beyond 2010, the initiatives to strengthen London's competitive position will be in full swing and should be yielding visible benefits. Regulatory reform will have been enacted and a fully operational talent exchange programme between industry and regulators should be in place. The London promotions board will be fully operational. The work undertaken on tax issues during 2009 should lead to the publishing of HM Treasury proposals on new tax policies regarding overseas profits and a policy statement on the competitiveness of the UK's tax rates. Plans for the new data centre facility will have been implemented. Finally, the talent programme should be coming to fruition, with an Indian and Chinese university locating in London and industry and authority support programmes for London universities formally established.

Who will lead the effort

The ambitious programme proposed by the Review calls for decisive and energetic leadership from industry executives, the Mayor, the Corporation and HM Treasury and Government more broadly. The principal roles for each of the leaders, or groups of leaders, would be as follows.

There are two principal roles for industry leaders. The first would be to contribute expertise and experience to each of the five proposed initiatives – for example, by contributing technical expertise and comment to developing new regulation, sitting on the new London promotions board and participating in working groups to establish the new data facility. The second role would be to contribute resources – including budgets, infrastructure and talent – to each of the initiatives as appropriate.

In taking the lead to create the new Financial Services Board, the City of London Corporation will work with the GLA and other interested parties to bring greater co-ordination to the promotion of London as a financial centre.

The Mayor would play a central leadership role in the implementation of the initiatives. He would need to provide vocal support to each of the initiatives, particularly where tough changes are called for, as is the case with the tax regime. He would contribute financial support and subject input to the London promotions board. He would take the lead on infrastructure issues and in exploring the potential for the new data facility. And finally, he would commit publicly to the achievement of some major milestones in the talent programme, such as attracting an Indian and Chinese university and achieving an ambitious number of new scholarships.

HM Treasury and Government more broadly would also have important roles to play in implementing the initiatives successfully. These would include leading the regulatory review and driving the recommended improvements in the UK's tax regime – including making a statement on tax rates and approaches and appointing a tax benchmarking panel, perhaps through the Chancellor's High Level Group. Finally, the Government would be responsible for creating an overall plan for financial services talent as part of that Group's mandate.

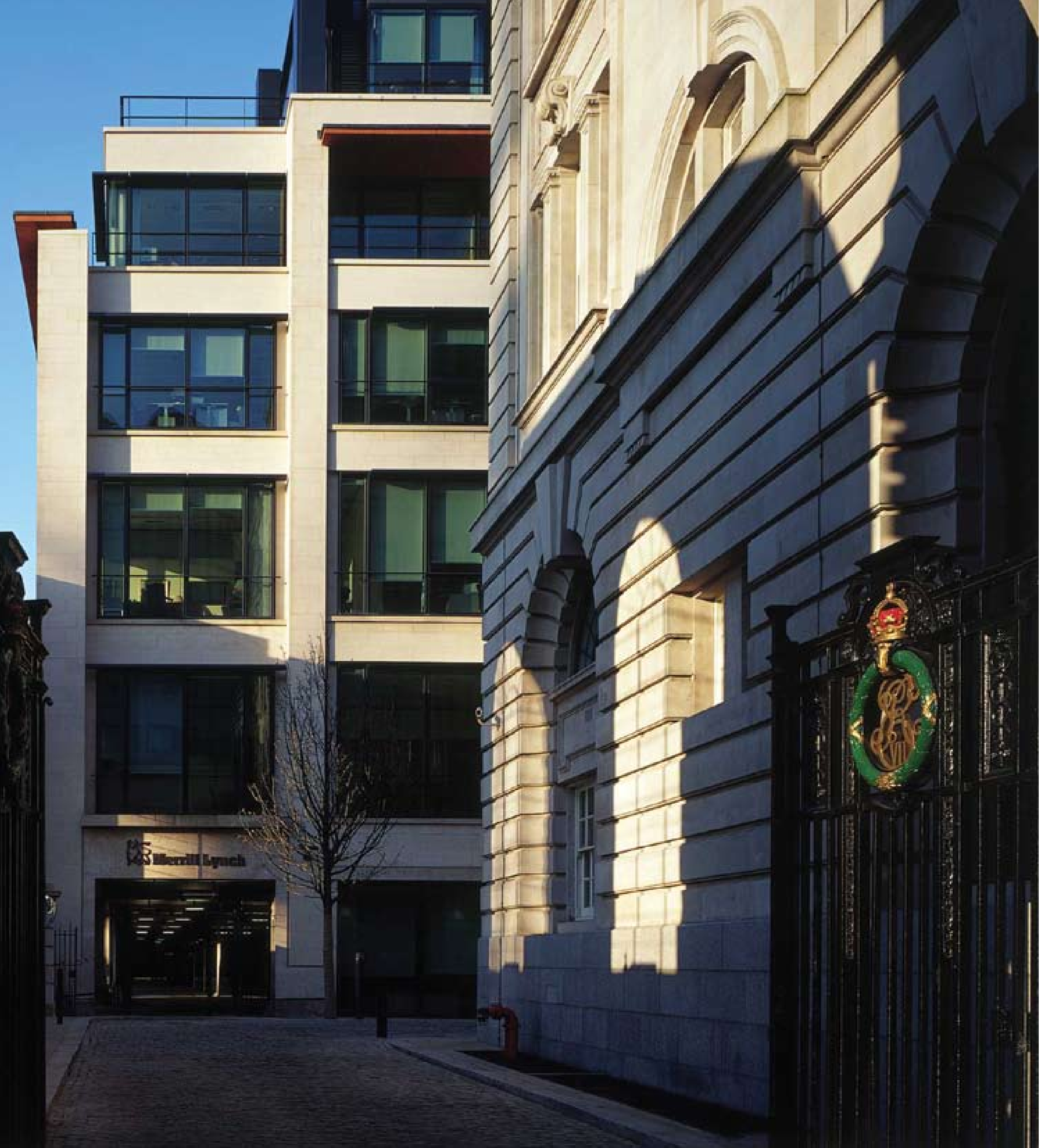
> The ambitious programme proposed by the Review calls for decisive and energetic leadership from industry executives, the Mayor, the Corporation and HM Treasury and Government more broadly.

Conclusion

This report has sought to cast a light on the tremendous value that London's financial centre creates for the capital and for the UK. Well before the financial crisis struck, this value was coming under threat. Today, in the wake of the crisis, the task of defending and sustaining London's competitive position is a more challenging one than ever.

Nonetheless, London has an extraordinary array of talented, entrepreneurial people and a powerful capacity for innovation and resilience. The authors of the Review are confident that leaders across government and industry can take the steps necessary not only to protect London's competitiveness as a world financial centre, but to enhance it considerably in the years ahead. The recommendations contained in this report are our particular contribution to that task. We recognise that many others are already working towards the same objective.

Most of all, though, we commit ourselves to working with a new degree of energy and collaboration to safeguard and strengthen the great city that nurtures our industry. We invite our colleagues and fellow Londoners, in both the public and private sectors, to join with us in this mission.



... London has an extraordinary array of talented, entrepreneurial people and a powerful capacity for innovation and resilience.

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Exhibit Sources

Exhibit 1: McKinsey Global Institute

Exhibit 2: Calculations and estimates by International Financial Services London, based on data published by Bank for International Settlements, London Stock Exchange, Bank of England, Systematics International, International Securities, Market Association, World Federation of Exchanges, EuroHedge and International Union of Marine Underwriters, Bond Market Association, European Securitisation Forum, Reserve Bank of Australia, Fitch Ratings, EVCA/Thomson Financial/PwC

Exhibit 3: Dealogic

Exhibit 4: Office for National Statistics

Exhibit 5: Annual Business Inquiry; Labour Force Survey; Office for National Statistics; London School of Economics; International Financial Services London; The British Private Equity and Venture Capital Association; Association of British Insurers; The Economist

Exhibit 6: Office for National Statistics, HM Treasury, HM Revenue & Customs, International Financial Services London

Exhibit 7: Executive interviews

Exhibit 8: Executive interviews

Exhibit 9: Financial Services Authority; executive interviews

Exhibit 10: Association of Bermuda Insurers; European Fund and Asset Management Association; Investment Management Association; Swiss Financial Sector Masterplan; Dubai Strategic Plan; Financial Times

Exhibit 11: Agency websites

Exhibit 12: Executive interviews

Exhibit 13: Executive interviews

Appendix 1: Interviewees and workshop participants (not exhaustive)

ANDREW BEAZLEY
Deputy Chairman, Beazley Group plc

GAEL DE BOISSARD
Managing Director, Head of Global Securities, Credit Suisse

EDWARD BONHAM-CARTER
Chief Executive & Chief Investment Officer, Jupiter Asset Management

TIM BREEDON
Group Chief Executive, Legal & General Group plc

AIDAN BRENNAN
Partner, European Head of Business Performance, KPMG

NATHAN BOSTOCK
Chief Financial Officer and Executive Director, Abbey

JOHNNY CAMERON
Chairman Global Markets, Royal Bank of Scotland

DOMINIC CASHMAN
Executive Director, Lehman Brothers

STEPHEN CATLIN
Chief Executive and Deputy Chairman, Catlin Group Limited

RICHARD COLLIER-KEYWOOD
UK Managing Partner and Global Leader Tax, PricewaterhouseCoopers

ELIZABETH CORLEY
Chief Executive Officer, Europe, Alliance Global Investors

PETER CORNELL
Managing Director Stakeholder Relationships, Terra Firma Capital Partners Limited

DAVID CRUICKSHANK
Chairman of the UK Board of Partners, Deloitte

SIMON DAVIES
Chairman, Threadneedle

PROFESSOR MICHAEL DEVEREUX
Director of the Oxford University Centre for Business Taxation

GLENN EARLE
Chief Operating Officer, Goldman Sachs International

VERNON EVERITT
Managing Director Marketing and Communications, Transport for London

JOHN FLINT
Group Treasurer and Deputy Head of Global Markets, HSBC

HAMISH FORSYTH
President, Capital Group Corporate International

PROFESSOR CLEMENS FUEST
Research Director of the Oxford University Centre for Business Taxation

MARK GARVIN
Chairman of Treasury and Securities Services International, JP Morgan

ALASTAIR GIBBONS
Partner, Bridgepoint Capital

JOHANNES DE GIER
Chief Executive Officer, Julius Baer Holding Ltd

MARTIN GILBERT
Chief Executive, Aberdeen Asset Management

DAVID GOLD
Senior Partner, Herbert Smith

JAN GOWER
Vice President, IBM Global Business Solutions

SCOTT HALLIDAY
UK Country Managing Partner, Ernst &Young

MARC HARDWICK
Head of Strategy and Sectors, ThinkLondon

MRIDUL HEGDE
Director of Financial Services, HM Treasury

ROBERT HESLETT
Vice President of the Law Society and Partner, Beachcroft LLP

MICHAEL HINTZE
Chief Executive Officer, CQS Management

PETER HUNT
Managing Director, BritishAmerican Business

CHARLES ILAKO
Global Financial Services Regulatory Partner, PricewaterhouseCoopers

ARCHIE KANE
Chief Executive, Scottish Widows

TOM KING
Head of Banking for Europe, Middle East and Africa, Citigroup

ELI LEDERMAN
Chief Executive Officer, Turquoise

JONATHAN LIPKIN
Head of Research, Investment Management Association

BRONEK MASOJADA
Chief Executive, Hiscox

DR RAYMOND MADDEN
Executive Director, Learning and Professional Development, Institute of Chartered Accountants England and Wales

DAVID MAXWELL
Chairman of London, Grant Thornton

HEATHER MCCALLUM
Partner, Head of Risk & Compliance, Allen & Overy LLP

DAVID MCINTOSH
Chair of City of London Law Society and Solicitor, Fox

NICOLAS MOREAU
Group Chief Executive UK & Ireland, AXA

DOMINIC MURPHY
Partner, Kohlberg Kravis Roberts

DAVID NICOL
Chief Administrative Officer Europe, Morgan Stanley

JEREMY PALMER
Chairman and Chief Executive Europe, Middle East and Africa, UBS Investment Bank

CARL PARKER
Partner, Permira Advisers

GORDON PELL
Chairman Regional Markets and Executive Director, Royal Bank of Scotland

FRANCK PETITGAS
Global Co-Head of Investment Banking, Morgan Stanley

JOHN PHIZACKERLEY
Chief Administrative Officer Europe, Lehman Brothers

STUART POPHAM
Senior Partner, Clifford Chance

PETER RANDALL
Chief Executive, Chi-X

BRUCE RIGAL
Chief Operating Officer Global Banking, Deutsche Bank

PAUL RUDDOCK
Chief Executive and Co-Founder, Lansdowne Partners

Interviewees and workshop participants (cont'd)

RICHARD SAUNDERS
Chief Executive, Investment Management Association

TERESA SAYERS
Chief Executive, Financial Services Skills Council

JOHN SEROCOLD
Director, London Investment Banking Association

PAUL SEWARD,
Head of Strategy Implementation, HSBC Bank plc

ANTONIO SIMOES
Group Head of Strategy, HSBC Holdings

KEITH SKEOCH
Chief Executive, Standard Life Investments

JONATHAN TAYLOR
Director General, London Investment Banking Association

BLAINE TOMLINSON
Chairman, Financial Risk Management

BARONESS JO VALENTINE
Chief Executive, London First

PETER VIPOND
Director of Financial Regulation and Taxation, Association of British Insurers

SIMON WALKER
Chief Executive, British Private Equity and Venture Capital Association

GRAHAM WHITE
Executive Partner, Slaughter and May

RICHARD WILSON
Partner and Investment Committee Member, Apax Partners

JOHN WINTER
Head of Investment Banking for Europe, Barclays Capital

SIR STEPHEN WRIGHT, KCMG
Chief Executive Officer, International Financial Services London

PETER YANDLE
Executive Director Marketing & Corporate Communications, Fidelity International

BOB YERBURY
Chief Investment Officer, Invesco Perpetual

Appendix 2: London's growing data communications infrastructure requirements

Although the image of the financial markets is one of individual traders taking in market information from screens and then placing trades over the telephone, the future of trading is increasingly an electronic one. By some estimates, over 40 percent of all trades are now governed by automated processes without the need for human intervention and this continues to increase. This has a consequential impact on increasing market data rates and traffic and therefore on the required data communications infrastructure.

Two other key factors are important:

- Growth in execution venues. Major changes in the regulation of market trading, led by the Market in Financial Instruments Directive (MiFID), have stimulated competition between traditional stock exchanges across Europe and have given birth to a number of Multilateral Trading Facilities (MTFs). These now compete with the traditional execution venues or exchanges. Many of these new market entrants, such as CHI-X and Turquoise, have recognized the importance of London as a centre of electronic trading and set up operations in London. In addition to the traditional "lit" execution venues (i.e. those whose prices are displayed to the market) there are an increasing number of "dark" liquidity pools such as ITG POSIT, Liquidnet and NYFIX Millennium, which aim to facilitate large block trades of orders with little or no market impact. The growth in this category of execution venue is illustrated by the London Stock Exchange recently announcing a new "dark" liquidity pool called Baikal.
- Growth in high frequency algorithmic traders. Over the last five years there has been a significant growth in high frequency algorithmic traders. These have sophisticated software algorithms that detect changes in the market or arbitrage opportunities between different trading venues. These hardware and software systems are optimised to react in milliseconds and place large amounts of orders to exploit any market advantage they may see. The companies that use them can place very large volumes of orders and trades and contribute a significant percentage to overall trade volumes. The growth of algorithmic trades is resulting in a number of impacts. First, the average size of a trade is decreasing and so there are more trades required to complete a given individual order. Second, as algorithmic traders "probe" the order books by placing "quotes" on the order books of execution venues, the quote to order ratio is increasing. This is driving market data rates higher. Third, as high frequency algorithmic traders aim to place orders faster than anyone else, a latency "arms race" is being fought between major market participants with key players "proximity hosting" their computer servers as close as possible to the execution venues they trade on.

As the market moves increasingly to electronic trading, the volumes of trades will continue to increase, with corresponding demands on the data infrastructure required to support electronic trading. This is putting an increasing strain and cost on the data communications infrastructure required to support electronic trading. Circuit bandwidths required to support many of the data feeds are now approaching or exceeding 100 Mbps. Above this level, the costs can become prohibitive and in many cases the data communications infrastructure may simply not be available in a given locale to connect the market participant to the execution venue.

This issue is compounded by the growth of the execution venues – not only does each "connection" to a market cost more, but more individual connections are required. In addition to these issues, the latency arms race is causing anyone who is latency sensitive to co-locate their servers and computer hardware at or close to each execution venue. As well as a cost issue, this has significant energy usage issues as market players distribute their servers across many different data centres. This is energy inefficient in its own right. Further, as many data centers are not up to the latest efficiency standards there can be a considerable carbon footprint from the high power servers used.

Appendix 3: Detailed proposals for tax reform

This Appendix provides further detail and reasoning on the Review's specific proposals for tax reform for consideration by HM Treasury.

Some of these proposals, if implemented, could involve a short-term cost to the Exchequer. The authors recognise that the public finances are under pressure. The proposals will take some time to develop and can only be implemented over time as overall budget constraints permit. The Review has also established, however, that the required analysis and data does not currently exist to enable an informed assessment of the short-term cost versus medium-term gain that the proposals would create. The authors believe that the proposals in this section would, if implemented, have the effect of attracting more banks and companies to base their headquarters or holding companies in London and create significant new employment. This in turn should create a "cluster effect" of additional tax revenue (including corporation tax, PAYE, NIC, VAT and other taxes) which could more than pay for any short-term loss in corporation tax.

One of the immediate workstreams for the Chancellor's High Level Group should therefore be to commission an independent study to examine how predictable, competitive and constructively applied the UK's tax regime is by international standards and to test the likely costs and benefits of the Review's specific ideas. This exercise should be carried out by Oxford University's highly regarded International Centre for Taxation. (**See Box at right: Proposal for annual benchmarking of the tax competitiveness of London as a location for financial services industries and headquarters of multinational firms.**)

The Review's three main proposals on strengthening the tax regime are detailed below:

- Improve the process of introducing new tax policy
- Use the tax system to reinforce the UK as the most attractive geographic location for companies to base their headquarters or regional holding companies
- Set out a strategic policy for corporation tax, to demonstrate the UK's intention to remain competitive in an increasingly challenging global tax environment

Proposal for annual benchmarking of the tax competitiveness of London as a location for financial services industries and headquarters of multinational firms

The Chancellor's High Level Group should annually commission the Oxford University Centre for Business Taxation to produce an independent analysis of the competitiveness, predictability and constructive application of the UK's tax regime. The position of London would be compared to competitor locations. For financial services firms, these include Dubai, Dublin, Frankfurt, Hong Kong, New York, Singapore, Tokyo and Zürich. For headquarters of multinational firms, London's competitors are more numerous and include many European countries such as Germany, France, Italy, Spain, Belgium, Ireland and the Netherlands.

The report would focus primarily on corporation tax. However, attention would also be paid to other taxes which may have a significant impact on the location of financial services firms and multinational headquarters. These may include the income tax treatment of highly qualified and internationally mobile employees, stamp duty and some specific aspects of VAT.

In considering the competitiveness of the UK's corporation tax, any comparison would need to consider not only headline tax rates, but also factors determining the tax base. These include depreciation rules for capital investment, the tax treatment of capital gains and losses, the tax treatment of reserves, loss of offset rules, regimes for taxing foreign profits, possible restrictions on the deductibility of financing costs, tax credits, special tax regimes, source taxes on dividends, interest, royalties and similar payments, the existing network of double taxation agreements and other sector-specific aspects of the tax system. In addition, to consider predictability and constructive application of the tax, it would be necessary to consider also how tax policy is formulated, how frequently reform is undertaken and how tax is administered.

To make meaningful comparisons, the complexity of existing tax systems has to be reduced for the purpose of analysis. Tax indicators must be developed which take into account the interaction of tax bases and tax rates as well as the impact of the type of economic activity under construction (financing structures, legal form, the sector specific structure of assets and liabilities). Effective average tax rates offer a method to achieve this. The Oxford Centre would develop two types of effective tax rates which could be used as indicators for tax policy benchmarking.

1. An effective corporation tax rate for the financial services industry

This effective tax rate would combine the aspects of the tax system which are most relevant to the financial services industry. The relevance of tax rules for the financial services industry depends on the specific activities and asset structures of financial services firms. The project would determine the most relevant tax rules on the basis of the financial statement data of financial services firms and consultation with professional firms. The report would provide a summary indicator of the tax burden faced by the financial services industry in the major financial centres.

2. An effective corporation tax rate for headquarters location

The effective tax rate would combine the aspects of the tax system which are most relevant to the locations of headquarters of multinational firms in all sectors. For this indicator, special attention will be devoted to the tax regime for foreign source dividends, double taxation agreements, and group taxation regimes including loss offset. Again, the research project would determine the most relevant tax rules on the basis of balance sheet data of multinational corporations and consultation with professional firms. The report would provide a summary indicator of the tax burden faced by headquarters in major industrialised countries and typical headquarter locations.

The project would also address the following.

3. Other aspects of the tax system

The report would investigate the role of specific aspects of other taxes, as noted above. Where appropriate, such taxes can be incorporated into an overall measure of the tax burden. In other cases, a separate comparison will be made.

4. Predictability and constructive application of the tax regime

Other aspects of the implementation of tax regimes can also be important for business. These include the stability of the tax regime and how it is administered. The project would also investigate these issues. Important factors to be considered are the process for considering potential tax reforms and the costs of the complying with the tax system. Some of these factors are less suitable for independent analysis and in such cases more reliance on surveying professional opinion would be required.

The first annual report produced by the Oxford Centre would involve a more significant one off effort with subsequent annual reports looking at trends and changes. The Oxford Centre should also be commissioned by the Chancellor's High Level Group to generate the cost benefit analysis to assess the likely impact over time on the Exchequer of the proposed specific tax changes identified above, working closely with HM Treasury and HM Revenue & Customs.

Improve the process of introducing new tax policy

The issues at stake around consultation are as follows. Businesses make investments on long lead times and return periods. They therefore require certainty, in as far as possible, over tax policy and potential changes as it makes it harder to calculate return on investments when the tax treatment is uncertain or is liable to change in direction with no or little notice. Businesses therefore wish to clearly understand government policy and have as much notice as possible of changes and the direction of change. Open consultation should also ensure that, in as far as possible, legislation is correctly drafted to achieve its objectives and that, even where market participants do not agree with the outcome, the policy objective is achieved without unintended consequences and confidence in the tax system is so maintained.

Consultation, however, causes an objective difficulty for government. On the one hand, if consultation is started too early before policy and its implementation approach has been clearly worked up, there is a danger that poorly drafted or kite flying proposals will create concern and confusion among taxpayers. Taxpayers may feel there is a hidden agenda; there may be considerable protest and resistance; and any perceived "u turns" by government will be embarrassing. On the other hand, if there is insufficient consultation, there is a risk that government will not fully understand the potential implications of legislation and that unintended consequences may result.

The Review's recommendation to improve consultation is as follows. We recommend that a small panel of experts (say six to ten people) be formed by HM Treasury and HM Revenue & Customs (HMRC), including senior representatives from the tax profession and senior business executives, with the mandate to review proposed policy changes and legislation on a strictly confidential basis before they are put out for wider consultation. Having a standing committee should ensure continuity and strategic overview of tax changes. Where the standing committee does not have the best expertise to comment on a particular piece of specialist legislation, it should have the mandate to bring in leading specialists, such as specialist tax QCs, as required.

The work of the committee would be to review proposals before they were released for wider consultation and ensure that those so released were adequately thought out and drafted and the impact on businesses and competitiveness carefully considered. The committee would not in any way take away the need for subsequent full consultation, but should reduce the risk of proposals having to be totally redrafted or withdrawn – or of unnecessary alarm arising from potential implications that government had not considered. The tax advisory industry should be prepared to provide their support to the Government on a pro bono basis. The standing committee would have a legal obligation of secrecy, breach of which would be a criminal offence.

The Review also recognises that it is difficult to have a genuinely constructive consultation process where there is an environment of mutual suspicion between HMRC and companies. Following the 2006 Review of Links with Large Business (the Varney Review), HMRC has made some positive moves to understand business better and to work efficiently with taxpayers to resolve disputes. It is in neither party's interest to engage in protracted disputes – and possibly unnecessary litigation – where the outcome is uncertain and significant management time is tied up in unproductive work. By contrast, experience shows that building a transparent and open relationship enables enquiries and disputes to be settled more quickly and efficiently, to the benefit of all parties. Such an improvement in working relationships also assists the overall consultation process. Indeed, a recent KPMG survey found that two thirds of companies interviewed believed that the Varney Review had resulted in better consultation with business.

Improved relations between HMRC and businesses, and an attitude amongst companies toward an open, transparent relationship with HMRC, can clearly result in better tax administration to the benefit of both HMRC and taxpayers.

Use the tax system to reinforce the UK as the most attractive global headquarters location in Europe

Currently, if a company is tax resident in the UK it is subject to UK tax on all its profits wherever earned. This means that foreign branches of a UK company are subject to UK tax on their profits and dividends repatriated from foreign subsidiaries are taxed in the UK. The UK gives a tax credit for any foreign tax on the foreign profits. In some cases, the UK will even tax profits earned in foreign subsidiaries immediately rather than when they are distributed to the UK. This is under anti-avoidance rules known as the controlled foreign company (CFC) legislation.

The above rules act as a deterrent to groups locating their parent company, or possibly a regional holding company, in the UK. In a globalised economy where capital may well be provided by non UK investors and invested in activity outside the UK, there is a very strong case that the UK should not tax the profit flows. In other words, the UK should move to a "territorial" base of taxation which means it would only tax profits earned in the UK.

In June 2007, HM Treasury issued a discussion document called "Taxation of the foreign profits of companies: a discussion document".

Following considerable debate on the above issues, Government announced a number of reforms in the Pre-Budget Report on 24 November 2008 including an exemption for foreign dividends.

The Review's recommendations on using the tax system to attract company headquarters are as follows.

Foreign dividends should not be taxed when repatriated to the UK

As stated above, it has been announced in the Pre-Budget Report that an exemption system will be introduced in the Finance Bill 2009. At the date of writing, the draft legislation has not been released. It is understood however, that the exemption will be broad and allow dividends to be repatriated free of UK tax irrespective of the size of the shareholding or the rate of foreign tax which has been paid on the profits. Such a regime would be welcome and should benefit both business and the economy at large. In a recent survey by KPMG of 50 of the UK's largest businesses, 56 percent said that were a dividend exemption system to be brought in, they would repatriate cash to the UK that is currently held offshore. To maximise the benefits of the regime, it is important that it is both broad in scope and simple to apply.

HM Treasury has estimated that the cost of introducing exemption would be around £900m. This is on the basis that tax on foreign dividends is currently around £300m. They also expect that tax of around £600m would be lost because of taxpayers altering their behaviour due to the exemption.

It is recognised that a risk with an exemption system is that taxpayers will be encouraged to divert profits from the UK to lower tax countries believing that they can then dividend the profits back to the UK without any further tax. It has been announced in the Pre-Budget Report that the new rules will contain anti-avoidance provisions and it is accepted that this is necessary. However any rules should be clear in their application so that companies have certainty about when the exemption will apply. Industry will need to co-operate responsibly to ensure any anti avoidance provisions are drafted effectively.

Exempt foreign branches

Where a UK company operates through a foreign branch it will be automatically taxed in the UK on its foreign profits (subject to double tax relief) and, in most cases, is able to deduct losses made overseas against its UK taxable profits.

It is proposed that branches should also be exempt from UK tax. This would mean that there is no distortion between the decisions to set up a foreign branch or a foreign subsidiary as the profits from both type of entity would not be subject to UK tax.

However, simply exempting branch profits would cause a considerable cost to companies that currently are able to obtain benefit for foreign branch losses. It is therefore proposed that companies would be able to deduct foreign losses in the same way as at present. When the branch becomes profitable, the loss relief given would be clawed back but any excess profit would not be taxable. In other words, the relief for companies would be a timing benefit only and the potential cost to the Exchequer would be limited. The immediate cost to The Exchequer of such a change would be equal to the amount of tax currently collected on branch profits. We do not know this figure but it is unlikely to be significant as companies will either be claiming double tax relief or will structure investments in low tax countries through subsidiaries in order to prevent the profits being automatically taxed in the UK.

As with the exemption for foreign dividends referred to above, it is recognised that anti-avoidance rules will be needed to stop companies artificially diverting profits from the UK into overseas branches and that industry should co-operate to ensure their design is effective.

Amend the Controlled Foreign Company Rules so that they only target profits actually diverted from the UK

The CFC rules are highly complex. Broadly, where they apply, the profits for foreign company are attributed to the UK parent and immediately taxed in the parent's hands. There are a number of exemptions to the rules but they do not always apply. In particular, where one foreign subsidiary lends money to another or licences intellectual property to another the profits will often be taxed in the UK. There is a concern amongst business that the rules prevent commercial structuring of overseas activities or the use of accepted ways of mitigating foreign tax and this puts UK based multi-nationals at a competitive disadvantage.

As part of the discussion on the taxation of foreign profits mentioned above, significant changes to the CFC rules were originally proposed, but it became clear the new proposals could be more onerous and costly than the original rules and they were consequently dropped.

In the Pre-Budget Report, it was announced that Government will continue to examine options to reform the CFC rules so that they achieve the objective of "taxing profits diverted from the UK" and not "profits which are genuinely earned in overseas subsidiaries". Again this is a welcome announcement. However, indications are that it is likely to take at least two years to achieve. The Review recommends that this process be expedited, potentially by using the proposed expert standing committee.

Furthermore, there should be a clear Governmental statement that, in the interim period, the existing rules will be applied in a way which reflects the move to territorial taxation.

It is understood that the current tax take from the CFC rules is low but HM Treasury consider that tax protected by their existence amounts to single digit billions. It is therefore clear that anti-avoidance rules would need to be introduced to prevent companies artificially diverting profits from the UK if the general rules were abolished. Again, industry should co-operate responsibly to ensure the design of these rules is effective.

Clarify the definition of residence for companies

Under current rules, a company is UK tax resident if it is incorporated in the UK or if its so called "central management and control" is in the UK. The latter test has been developed over many years through case law. In practical terms it usually means that if the board of directors meet in the UK the company is UK resident. There are many cases where foreign enterprises, particularly new and fast growing companies, wish to locate their key executives in the UK to access the financial and business centre of London. At the same time, such companies do not want to be subject to the UK's onerous rules on the taxation of foreign profits.

The central management and control test results in such companies having to be very careful about who is employed in the UK and about what activities take place in the UK. Often directors are instructed not to take certain decisions or to call in to board meetings from the UK or to sign board resolutions in the UK. These concerns inevitably restrict the company's flexibility to manage itself, so creating cost.

It is proposed that the definition of residence is clarified, either by guidance or by statute, so that it is easier for a company to determine what actions would make it UK resident. In particular, employing executive officers in the UK and telephoning in to board meetings from the UK should not make the company UK resident.

Use corporation tax policy to make the UK competitive
Corporation tax is a cost of operating a business and with statutory rates coming down globally, the UK needs to act to maintain its competitiveness. It is accepted that there are many components to a competitive regime and the statutory rate is only one. Furthermore, the UK cannot cut its rate every time another leading financial centre does. However, it would send out a strong signal in the business community if there was a policy of keeping the statutory rate in, for example, the lowest decile of the leading financial centres in the EU. This has broadly been the de facto policy of successive Governments for some time. Subject to an allowance for extraordinary circumstances, the Government should therefore consider formalising its policy in a public commitment for each Parliament. An example of such a public commitment is the policy adopted by the Canadian government in 2007 in its comprehensive overhaul of its tax system (**see Box: Canada's aspiration for the lowest tax in the G7**).

Canada's aspiration for the lowest tax in the G7

"To improve productivity, employment and prosperity in an uncertain world, a bold, new tax reduction initiative will reduce the general federal corporate income tax rate to 15 per cent by 2012 from its current rate of 22.1 per cent. The general corporate income tax rate will decline by 7.12 percentage points between 2007 and 2012 – giving Canada the lowest overall tax rate on new business investment in the Group of Seven (G7) by 2011 and the lowest statutory tax rate in the G7 by 2012." (Economic statement, Canada Department of Finance, 23 October 2007)

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