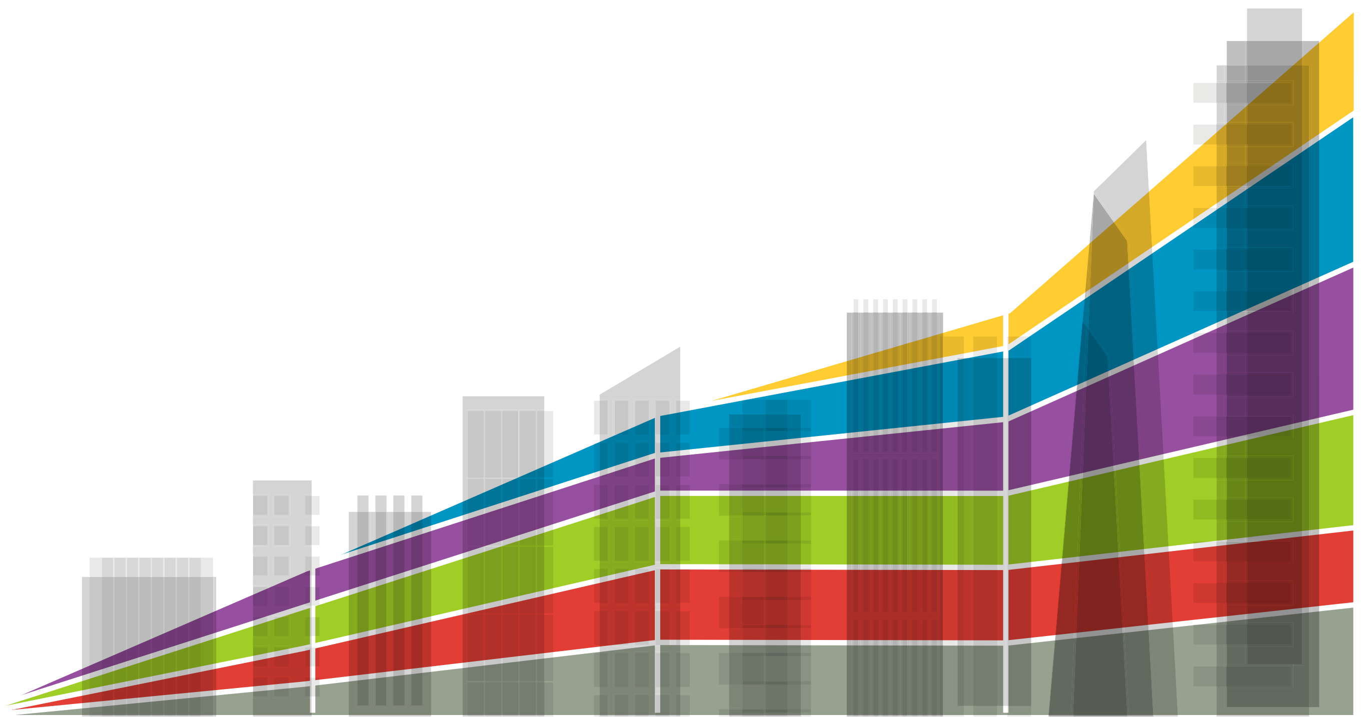
From local to global
Building a modern financial centre

SPECIAL INTEREST PAPER CITY OF LONDON CORPORATION



From local to global
Building a modern financial centre

SPECIAL INTEREST PAPER CITY OF LONDON CORPORATION

www.cityoflondon.gov.uk/**economicresearch**

From local to global: Building a modern financial centre is published by the City of London.
The author of this report is Bourse Consult.

This report is intended as a basis for discussion only. Whilst every effort has been made to ensure the accuracy and completeness of the material in this report, the author, Bourse Consult, and the City of London, give no warranty in that regard and accept no liability for any loss or damage incurred through the use of, or reliance upon, this report or the information contained herein.

November 2013

© City of London
PO Box 270, Guildhall
London
EC2P 2EJ

www.cityoflondon.gov.uk/economicresearch

Contents

1. Introduction 1

2. Overview of financial centres 2

3. Stages in the development of financial centres 3

Local financial centres 3
Opening up to foreign participants in the local market 3
Becoming a regional centre 4
Becoming an international financial centre 4

4. Characteristics of financial centres at different stages 5

Local financial centres 6
Opening up to foreign participants in the local market 7
Becoming a regional centre 8
Becoming an international financial centre 14

5. The factors that shape the development of a financial centre 10

The business environment 10
Financial market infrastructure 11
Regulation and law 13
People 15
Connectivity 16
Critical Mass 17

6. Conclusions 18

1. Introduction

The development of financial centres is of great interest to policy makers and businesses around the globe. From the development of basic financial market infrastructure in frontier markets, to centres seeking the transition to a multidisciplinary global financial centre, the development of financial centre capabilities provides significant benefits for a country's economic growth.

There are a number of reports that explore and compare key competitiveness factors contributing to the overall success of financial centres across the globe. [1]This report seeks to draw together published material and build on this to explore the key factors that underpin financial centres at different phases of their development, namely: local financial centres; centres opening up to international investment; regional financial centres; and international financial centres.

The report takes each of these stages in turn, identifying and exploring the key components that typically exist within financial centres at different stages of development. Competitiveness and infrastructure factors are reviewed, focusing on the business environment, financial market infrastructure, regulation, people, connectivity, and critical mass, all of which contribute to the development of a financial centre but are of differing relative importance at the various stages. Whilst this is not a blueprint for development, as there is no single path to the development of a financial centre, this report identifies a series of common themes and factors that underpin the growth of a financial centre as it develops.

[1] Including the Z/Yen Global Financial Centres Index, the World Economic Forum Financial Development Index, PwC's Cities of Opportunity, Kearney's Global Cities Index and the Economist Intelligence Unit's Hot Spots 2025: Benchmarking the Future Competitiveness of Cities (commissioned by Citi).

2. Overview of financial centres

A well-functioning financial sector is a vital component of a country's economic health. It helps fuel economic development and growth by enabling capital to be efficiently channelled into investment projects and by helping businesses to manage their risks.

The financial sector comprises a number of sub-sectors that facilitate the efficient functioning of an economy:

- Banking plays a key role. Banks intermediate between investors and borrowers both by enabling individuals to save and by using these deposits to lend to businesses, financial institutions, individuals and governments. In addition, they provide payment and settlement services, both domestically and internationally by carrying out transactions in the international foreign exchange (or FX) market.
- Bond markets are typically a source of long-term capital for governments and larger private sector businesses, and provide an alternative to debt finance offered by banks.
- The equity market (or stock market) is a source of risk capital for companies that need to finance their growth, in exchange for share ownership.
- Asset managers act on behalf of individuals and institutions, managing longer-term savings and planning pensions through collective investment vehicles, such as mutual funds. These funds are re-invested in financial markets, non-financial corporations and government agencies.
- Finally, insurance companies and reinsurers assist in the pooling and management of risk, facilitate trade and commerce, and act as major institutional investors providing additional liquidity to financial markets.

Financial services for retail customers are generally delivered through a distribution network with branches close to the end customer. Wholesale financial services on the other hand tend to cluster together in financial centres. This trend may seem surprising, given that technology now makes it possible to separate the location of people transacting business from the location where the business takes place. Location remains important, however; arranging complex transactions typically involves face-to-face contact and wholesale financial firms also need to draw on the skills of specialist advisers, such as lawyers and accountants, while having access to a large pool of skilled staff. So technology now enables financial firms to bring all of these people and services together in one place while still having access to markets across the globe. These factors support the effectiveness of clustering of wholesale financial services in financial centres, which have become increasingly concentrated in recent decades.

3.
Stages in the development of financial centres

Financial centres take time to evolve, and we can identify different stages in their development, as outlined below. Not all centres will follow the same path or aim for the same end point, but these descriptions characterise the main common features.

Local financial centres

As a financial centre grows in a developing economy, it initially serves a largely domestic group of participants. Local institutional and private investors purchase domestic securities, such as local government issued bonds, or shares and bonds issued by local firms. The domestic banking system services local retail and commercial clients. Market infrastructure, such as the payments system and exchanges, are simple and locally developed, possibly with restrictions on cross-border activity.

Opening up to foreign participants in the local market

As a country's economy grows and businesses develop increasingly sophisticated financing requirements, foreign investors become interested in investing in the country, while domestic firms stretch the domestic capacity to provide the capital they need to expand and begin to seek external sources of finance. More sophisticated financial markets provide the means for businesses to manage their risks. Initially, the focus is typically on enabling firms to protect themselves (or "hedge") against movements in prices through a futures exchange. This may start with equity or commodity contracts and move on to hedging against movements in interest and exchange rates and attract investors who are prepared to take on the risks that businesses want to avoid.

At this stage, a financial centre competes with others to attract foreign investment. Increasingly, the compliance of its domestic market infrastructure and regulatory regime with international standards comes under scrutiny. The government is likely to adopt policies to encourage foreign investment and ensure that foreign financial firms can operate on an equal footing with domestic firms. The market infrastructure evolves to meet the expectations of international investors and financial firms, and support the cross-border investment inflow.

Becoming a regional centre

In the next phase of development, financial centres adapt their services, regulation and infrastructure to make investment by foreign investors easier. Consequently, the number of investors confident in investing in the centres increases. The wider base of investors leads to deeper market liquidity, and the financial centre with the best expertise, connections and liquidity in the region becomes the natural "gateway" for investment in other countries in the region. It also becomes an attractive location for any major international financial institution looking to set up a branch or subsidiary from which to distribute products and services to clients across the region.

Participants within these centres develop regional and international expertise in more sophisticated cross-border financial products and services. They also form networks of clients, suppliers and counterparties which support this activity. The development of networks, efficient infrastructure and the concentration of specialised labour and suppliers within a financial centre cause further agglomeration of financial and related services.

Becoming an international financial centre

A further stage of development is for a centre to progress from regional importance to being internationally or globally significant. An international financial centre (IFC) is a hub where cross-border financial business with counterparties around the world can be conducted easily and efficiently. Among international financial centres, a small number stand out as truly global financial centres (GFCs). Their global reach derives from high levels of expertise in a range of financial products and services; from business networks which span the world; from collective liquidity which allows them to handle the largest transactions; and from their reputation for efficient markets and fair legal systems.

These qualities are built up over time and usually result from the financial centre's evolution through the stages described previously. For example, global financial centres like London and New York have developed as centres for trade and commerce over centuries, and their breadth and depth of knowledge and expertise reflect this.

The progression described is a broad generalisation. Most financial centres do not proceed all the way down this linear path; in a large, developed economy, it is possible to develop a sizable, sophisticated financial centre that is focused entirely on serving local participants. Alternatively, some financial centres develop specialised expertise in a specific type of financial market or service provision. These specialist centres have built up a high concentration of business in one particular sector, either as a result of the government creating tailored legal, regulatory and tax regimes to support the sector's development, or the self-reinforcing effects of agglomeration. Examples are Bermuda's cluster of reinsurance and captive insurance business and Dublin's position as a centre for the domicile and administration of managed funds.

4. Characteristics of financial centres at different stages

Six factors can be identified as having significant influence on the development of a financial centre. These are discussed in more detail in section 5.

Business environment
The ease and cost of doing business, political and economic policy and the quality of physical and technological infrastructure.

Financial market infrastructure
The extent and quality of the central infrastructure provided for undertaking financial market activity.

Regulation
The quality and extent of financial market regulation and its conformance to international best practice.

People
The availability of a qualified local workforce and the ease of relocating specialist expatriates into a centre.

Connectivity
The factors that connect a financial centre with the rest of the world.

Critical mass
The most important, but also most intangible factor, as the concentration of firms in a centre attracts more firms in a self-sustaining process.

For each stage of development, this section identifies the related key characteristics of a centre, and recommendations for encouraging financial development.

Local financial centres

Key characteristics of a successful local financial centre

- Financial markets predominantly serve local participants:
  - Banks based in the country serve domestic corporate and retail customers. Money saved by local investors is lent to local government, corporate and retail borrowers.
  - Banks provide financing for import and export.
  - Securities in the form of government-issued bonds and bonds or equities issued by local companies are sold to local institutional and private investors.
- A supportive business environment exists, allowing local financial markets to prosper.
- Policies which restrict international participation in financial markets may be in effect, such as foreign exchange controls or restrictions on foreign ownership of securities.
- The domestic financial market infrastructure supports local laws or market practices:
  - Most centres will have a stock exchange with an electronic trading system, a computerised Central Securities Depository (CSD) and an inter-bank payments system operated by the central bank.
- The domestic regulatory regime aims to build confidence in the centre's markets, by having:
  - Macro prudential regulation through effective supervision of the financial services industry.
  - Solid investor protection arrangements and rules to govern the conduct and creditworthiness of market intermediaries.
  - Listing rules to ensure that adequate and timely price-sensitive information is available to investors from security issuers.
  - Transparent market rules and prevention of conflicts of interest such as insider trading.
- Qualified local workforce trained in local rules and practices.

Areas for development

- Improving the domestic financial market infrastructure to make it more robust and consistent with international best practice standards
- Strengthening the legal and regulatory environment will encourage investor participation and increase activity in financial markets like the derivatives and bond markets.
  - Developing regulation that complies with international standards or best practice will increase the attractiveness of the local financial centre to foreign investors.
  - Increasing the presence of legal institutions to safeguard the interests of investors.
  - Reducing barriers to trade and investment, such as negotiating free trade agreements (FTAs) with other jurisdictions and removing discrepancies between the legal treatment of domestic and foreign investors through foreign ownership limits or differential shareholder voting rights.
  - Simplification of the tax regime and negotiation of double tax treaties to reduce the tax burden and provide certainty of treatment for cross-border trade and investment.
- Developing language skills and international financial market expertise will improve openness to foreign investment.
- Improving international communications links (both electronic and physical).

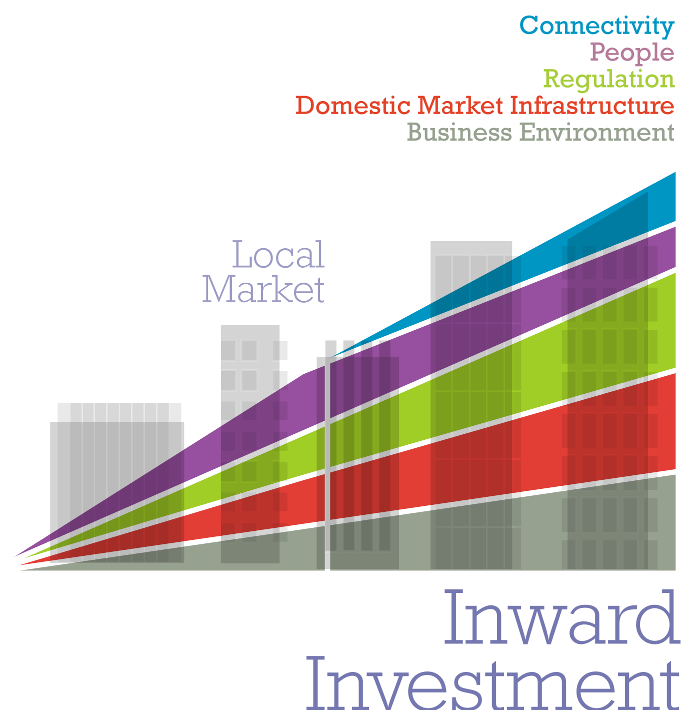
Opening up to foreign participants in the local market

Key characteristics of a centre opening up to foreign investors

- Financial markets become increasingly sophisticated, offering a wider range of instruments to borrowers and investors:
  - An increasing number of foreign-owned companies list on the domestic exchange or domestic companies seek listings on foreign exchanges, increasing the pool of available capital.
  - Bond markets become an increasingly important source of finance as firms seek to diversify from reliance on banks for funding and governments increase their borrowing.
- A stable and efficient business and political environment, including a well-developed legal system which reflects conventions of international law in areas of practice such as company law, insolvency, payment systems and securities legislation.
- As a centre starts to attract inward investment, its domestic market infrastructure and regulatory regime face increasing scrutiny in terms of compliance with international standards. The centre will now be working towards:
  - The adoption of international norms and recommendations, such as the Principles for Financial Market Infrastructures published by CPSS-IOSCO.
  - The adjustment of domestic payments systems, settlement systems and custody arrangements to improve investor confidence and ensure accommodation of other parties in different time zones.
  - The development of a regulatory structure which is in line with international standards.
- Reliable communications links with the rest of the world become important.

Areas for development

- Improve connectivity to international financial markets by:
  - Ensuring reliable market data from local exchanges is readily available to international investors.
  - Ensuring local brokers can accept orders routed electronically from overseas.
  - Ensuring securities are eligible for international settlement through an International Central Securities Depository (ICSD).
  - Offering international investors global depository receipts (GDR), which allows a foreign investor to gain exposure to the security without having to access the local market.



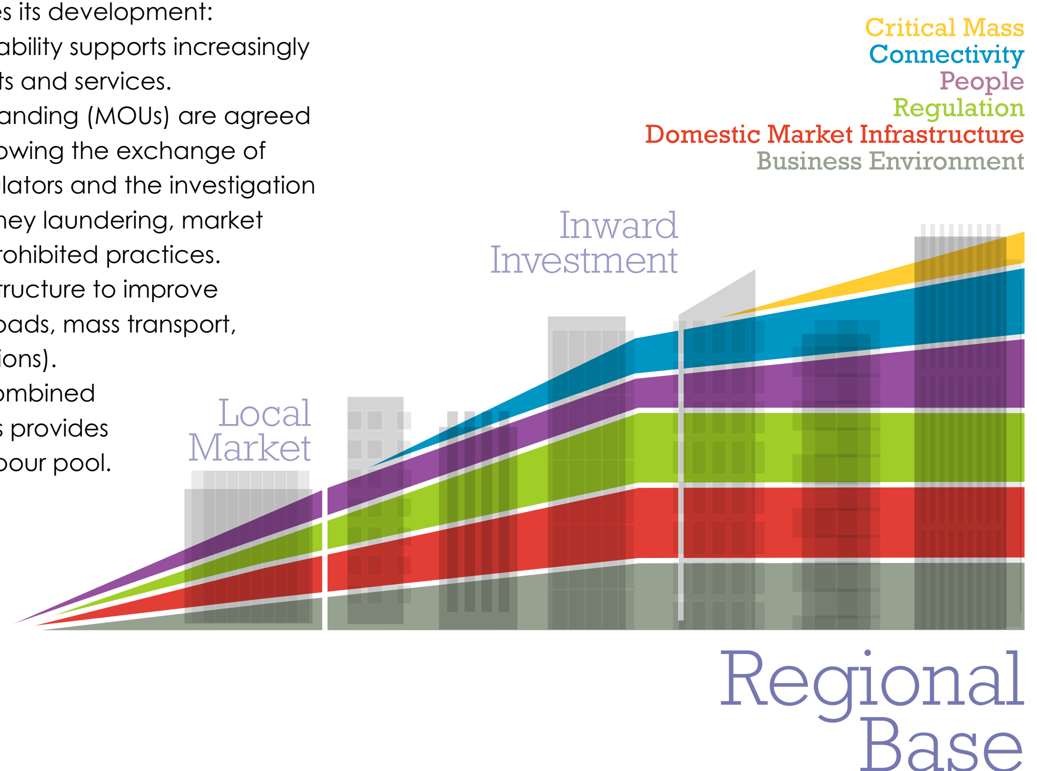
Becoming a regional centre

Key characteristics of a regional centre

- Financial markets serve the region as a whole, with international firms using the centre as a gateway to access regional markets:
  - Domestic exchanges will list shares in companies located in other countries.
  - In addition to domestic bonds, markets may offer regional or international bonds, usually issued by large companies, local or national governments and international organisations.
  - Derivatives trading will account for an increasing share of cross-border transactions as companies seek to manage or diversify risk portfolios.
  - Foreign exchange trading in regional currencies increases.
  - An increasing number of investors and range of instruments available will deepen the liquidity of financial markets.
- An attractive business environment for existing firms and those looking to locate within the centre. Encouraging firms to locate in the centre is key to success.
- Financial market infrastructure which meets international standards and progresses towards linking with the infrastructures of other regional centres.
- Regulation is supportive of the centre's role as a regional base, and facilitates its development:
  - Legal and regulatory capability supports increasingly complex financial products and services.
  - Memorandums of understanding (MOUs) are agreed with foreign regulators, allowing the exchange of information between regulators and the investigation of international fraud, money laundering, market manipulation and other prohibited practices.
- Investment in physical infrastructure to improve connectivity (air transport, roads, mass transport, office systems, communications).
- A high level of education combined with low immigration barriers provides a highly specialised local labour pool.

Areas for development

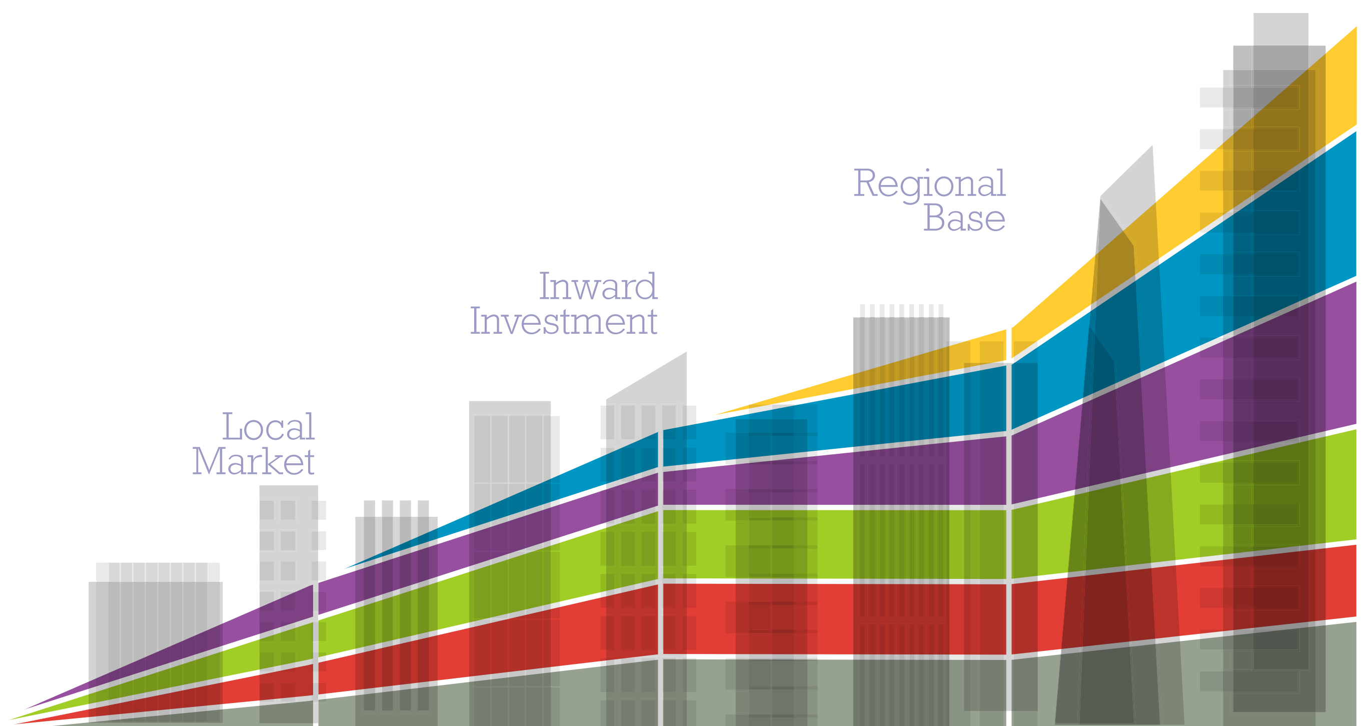
- Further develop links with international financial centres (through MoUs with overseas regulators and market infrastructures).
- Attract a greater breadth of firms to increase critical mass: asset managers, financial intermediaries and necessary support services.



Becoming an international financial centre

Key characteristics of an international centre

- The agglomeration of financial intermediaries, such as banks, brokers, investors, hedge funds and insurers, and related professions, such as lawyers, accountants and information technology specialists, provides high quality inputs and support services to the financial centre.
- Financial markets have deep market liquidity, contributed by a wide range of international financial services such as the international bond market, large volumes of transactions between counterparties globally, and being host to large numbers of domestic and international financial firms.
- Strong support for the financial services industry from government.
- A high standard of regulation is provided by regulators with deep industry knowledge and technical skills appropriate for complex financial business, reinforced through strong co-operative relationships between the industry and regulators.
- The centre is open to a highly-skilled, internationally mobile workforce with a depth and breadth of financial and related services' knowledge and experience, encouraged by government policy in immigration and education. A large local labour pool and flexible employment legislation allows firms to hire and expand in accordance with business need.
- High connectivity to other financial centres and international market infrastructures through electronic trading systems, providing fast, reliable data links coupled with remote access to financial markets, reducing the need for physical proximity in conducting global transactions. The firms within the centre have business connections with counterparties and clients across the globe.



5. The factors that shape the development of a financial centre

The preceding sections identified the various stages of development of financial centres, looked at the key characteristics of each stage and suggested the areas that could support further development. This section now looks in more detail at the main factors outlined previously, which shape the development of a financial centre.

The business environment

Financial services businesses are affected by the general business environment in a country, such as its growth, economic policy, tax rates, and the ease, speed and cost of putting business decisions into effect.

The firms that cluster in major financial centres are typically internationally mobile and will locate in centres that best meet their business needs. Financial firms look for governments to create a stable and transparent economic, legal and regulatory environment, provide clear information about local requirements and procedures, and give quick and predictable responses. The way in which interest rates, currency stability and monetary policy are managed by national institutions can have a significant impact on firms operating within a centre.

As employers, businesses, consumers and suppliers of services, financial and professional services firms are affected by the legal environment in a centre. Financial firms generally look for a centre where the legal system can facilitate complex financial transactions, the legal process is fair and transparent, outcomes are predictable and judgements are enforceable. There should not be a high propensity towards litigation. It also needs to be possible for foreign firms to acquire, merge with or partner with, local firms, that is, to have an open capital market.

A stable political environment is particularly important. Conversely, political instability, civil unrest or perception of corruption will hold back the development of a financial centre.

However, not everything that makes for a good place to do business is dependent on institutions. Financial firms depend on a large number of local services: voice and data telecommunication networks, data centre services, power supply, local transport and office accommodation with all the necessary support services. Government also has a role as a planning authority in permitting development of the physical infrastructure needed by financial firms. Financial services firms tend to be demanding customers, which stimulate a high quality, competitive body of local suppliers. They expect to be able to take it for granted that these services will be available whenever required and at reasonable cost.

Financial market infrastructure

The infrastructure for financial markets has come into greater prominence since the financial crisis of 2008. G20 countries have agreed a co-ordinated programme of change, much of which is focused on the infrastructure supporting the financial markets. In part this has involved a high level of international co-operation among regulators to agree common standards.

The principal elements of financial market infrastructure include the following:

Exchanges

It was trading between parties that originally led to the development of financial centres. Historically this took place in an exchange. A stock exchange typically provides a venue for trading securities, such as stocks and bonds, establishes the rules of the market place and determines which securities are eligible for trading. A commodities exchange does the same for physical commodities, which may trade for immediate delivery ("Spot") or as derivatives, such as futures or options, allowing for delivery at a future date. The latter can be used for hedging. A further development is the trading of financial derivatives, allowing firms to hedge their interest or exchange rate exposures. Trading can take place face to face on a trading floor, but the growth of electronic trading systems has meant that traders do not have to be located in the same country as the exchange. An exchange usually shares responsibility with the regulatory authority for maintaining standards in the marketplace.

However, many of the most active markets, including foreign exchange, many kinds of derivatives and many bonds, are not traded on exchanges but directly between market participants or intermediated through brokers in what is known as the Over the Counter or "OTC" market. A large part of the regulatory effort since the financial crisis has been to bring OTC market transactions within the scope of organised financial infrastructure and regulation.

Market information systems

Trading decisions need to be made on up to the second information. Therefore, the systems that collect, collate and disseminate both raw and value added financial market information are a key component of modern financial market information systems. For anything other than a purely domestic market, institutions rely on data providers that offer global coverage.

Clearing house or central counterparty (CCP)

A CCP manages the risks that exist between the time a trade is executed and the time when obligations are discharged between buyer and seller. CCPs are essential to derivatives markets and now part of the normal infrastructure for stock markets. Trades executed on organised exchanges will normally be transmitted automatically to the CCP for clearing.

In the event of a default, the CCP is responsible for ensuring that the obligations to non-defaulting parties, including the clients of clearing members, are satisfied. CCPs generally manage this risk by a combination of:

- Setting minimum financial requirements for firms allowed to clear through the CCP (known as "clearing members");
- Netting offsetting positions;
- Collecting collateral to cover the potential exposure if one party defaults; and
- Having additional funds available if the collateral is insufficient.

Following the decision at the G-20 Summit in 2009 to push for central clearing, CCPs now play a central role in clearing trades executed in OTC derivatives markets as well as those executed on exchanges.

Central securities depository (CSD)

A CSD enables investors to hold their securities in book entry form at a central institution. The CSD itself may hold the securities either immobilised (where all the physical certificates are held in a central vault) or in dematerialised form (where the securities exist only as electronic book entries). In either case it enables the transfer of securities from one investor to another to take place as book entries. A modern CSD should also manage the payments associated with securities transfers to support Delivery Versus Payment (DVP), ensuring that neither the buyer nor the seller is exposed to the risk of loss if the other party fails to deliver.

As the central depository, CSDs very often play a role in corporate actions, such as distributing dividends, and in supporting stock borrowing and lending and repo activities.

While most CSDs are national institutions, two International CSDs exist to service the international bond market. There are also moves to link together CSDs in particular regions to facilitate cross-border settlements. In Europe, the European Central Bank is building the T2S system to link CSDs in the Eurozone and some other countries and there is discussion about developing interoperability between CSDs in the ASEAN region.

Trade repository

Trade repositories collect and maintain information on OTC derivative transactions and make it available to participants and regulators in order to improve the transparency of markets that are otherwise rather opaque. Unlike the other parts of the financial infrastructure, they do not themselves process movements of money or other assets, but are a source of data for the market.

Payments system

Finally, a basic requirement of a financial centre is to be able to make payments. While many of these may be made through bank-owned systems such as cheques, inter-bank payments or, increasingly, mobile phone payment systems, they ultimately rely on the ability to make payments between commercial banks at the central bank. This should offer the possibility of Real-Time Gross Settlement (RTGS), that is, the ability to make a single payment immediately during the day. Special international infrastructure exists to handle the settlement of foreign exchange (FX) trading, which involves payment in two currencies, in order to avoid the exposures that would arise if the payment of one currency was made before the other.

Regulation and law

It is often assumed that internationally mobile financial services business flow to locations where regulation is lightest. However, successful international financial centres all have robust and well developed regulatory regimes and yet attract large volumes of international business. Financial services regulation – particularly of international business where the parties have a choice over where business is transacted – is a matter of balance. If regulation is too onerous business may move to avoid the high cost of compliance, a good example being the shift in international listings to London from New York in the light of the Sarbanes-Oxley act in 2002. Conversely, a lack of regulation will not attract the majority of players, even if it may attract some business from higher risk takers who think they can survive in such an environment.

The regulatory environment

A financial centre must strike the right regulatory balance so that intermediaries are willing to set up business in the centre and investors have confidence to transact business in the centre. When the balance is right it can help set the tone that the centre understands and welcomes international business. Some critical qualities are:

Clarity and predictability

Financial markets dislike uncertainty. When outcomes are unclear or inconsistent, market activity tends to reduce. The centre's regulations need to be clear, understandable, straightforward (although this has been increasingly difficult in recent times as products have become more complex) and predictable in their application. The regulatory institutions should operate in a transparent manner when developing new regulations and supervising firms.

Fairness

The regulatory regime must be seen to be fair; in particular, regulations should not discriminate between local firms and international firms operating within the centre. Firms will be less likely to establish business within the centre if they think that they could be operating at a competitive disadvantage.

Consultation on new regulations should include all market participants not just the local firms. Gathering opinion from foreign-based firms operating within the centre is a valuable way of ensuring that the regulatory regime does not deter new entrants.

Supporting market innovation

Successful financial centres host vibrant markets which are in a continuous state of evolution, developing new products and services to meet changing circumstances and customer needs. A centre's regulatory regime needs to adapt at the same rate and the regulatory authorities need to recognise that their role is not to unreasonably inhibit development. The authorities should allow new products and services to be brought to market, analyse their use and be prepared to introduce new regulation rapidly if abuses become evident.

Reasonable cost of compliance

The cost to intermediaries and institutional investors of complying with regulation has increased significantly in

recent years and continues to rise. When a firm decides to set up in an additional financial centre it has to accept a substantial additional cost to meet the requirements of the extra regulatory regime on entry to the centre and for continuing compliance. Each regulatory regime is different, so this will often require new systems and procedures and is likely to require staff with relevant knowledge and experience.

Law

The law of a country has a direct impact on the business of the financial institutions operating there in the following ways:

- An effective financial market infrastructure needs complementary legal support for the activities it undertakes. For example, laws are needed to ensure that settlement of transactions is final and irreversible and to support activities such as netting and novation by CCPs.
- Legislation should also ensure that clients' assets are protected from the failure of the institution holding them and to ensure that actions taken to settle transactions or manage a default cannot be subsequently unwound.
- Other sections of domestic law such as contract law, insolvency law, companies law, trust law, law governing collateral etc. can affect the types of products and services the firms can offer and the risks they take.
- Restrictions on cross-border financial flows, such as exchange controls, limits on foreign investment, taxes on inward or outward investment or requirements to use certain local banks for transactions can all impede cross border business.
- Should litigation be necessary, it is important that it will be heard by judges with a thorough understanding of the law relating to financial services and who will be able to make judgements consistent with market practice.

International standards

Operating in different regulatory regimes adds layers of cost and complexity to the operations of international financial service companies. Systems and procedures may have to be changed to meet these requirements (for example, requirements to hold data onshore and in local languages), increasing the cost of compliance. Operational risks may arise where a firm operates under multiple regulatory regimes. These costs add to the entry barriers and it is in the centres' interests to reduce them if possible.

For instance the adoption of International Financial Reporting Standards for local companies not only helps international investors to invest in those companies but also makes it easier for foreign companies to list their securities within the centre.

The financial crisis has placed a new emphasis on international regulatory standards. IOSCO[2] , CPSS[3] and BIS[4] have been developing standards which are much more detailed than previously and it is probable that all major international financial centres will adopt these standards into their own regulatory regimes. These standards still cover a relatively small part of the regulatory environment, however, and so merely adopting them will not ensure that the centre's regulatory regime is completely acceptable to international firms.

However, even where there are no international standards, there is often international good practice. If the centre's regulatory authorities adopt this wherever possible it can significantly lower entry costs for incoming firms. The financial industry itself often develops a framework of standardised documentation for conducting business. An example is the ISDA[5] documentation for OTC derivatives, which is now used for the great majority of transactions worldwide.

Cross-border friendly

A very important part of business conducted in an international financial centre will be with counterparties in other countries. The regulatory regime of the financial centre needs to accommodate the particular characteristics of cross-border activity and, where possible, to facilitate it.

Agreements between the centre's regulatory authorities and their counterparts in other financial centres to mutually recognise their respective regulations can help to reduce the regulatory burden of cross-border transactions.

People

People are the most important resource for international financial service companies. While local residents provide the majority of the professional, experienced workforce, they are complemented by a relatively small number of internationally mobile professionals, moving from country to country, following and developing business opportunities. The relationship between the two groups is very important. The international financial services professionals will typically be the people to establish and build the overseas operations of their business. They typically depend on being able to put in place professional experienced teams locally. The interaction between international and local staff is an important channel for increasing the knowledge and experience of the local workforce.

Businesses compete with each other to attract the most talented people and need to be able to deploy them wherever they are most needed. Similarly, ambitious finance professionals expect to advance their careers by moving between different centres to expand their experience and personal business networks.

One of the factors that have helped successful financial centres to develop has been their openness to an internationally mobile workforce. Employers and individuals look for stability, consistency and transparency in immigration rules. For example, employers may need to be able to transfer staff from one office to another, often at short notice. Or employers may need to hire people with specific language or industry skills, not available locally. If it is time-consuming, unpredictable or simply impossible to move people to one centre, it becomes more likely that they will move to an alternative centre instead.

While immigration rules are generally considered the most important constraint on international mobility, the general openness to foreign residents matters as well. Factors such as remuneration levels, personal taxation and the cost of living affect staff relocation decisions. Easy access to high quality housing, international schools, good health care, personal safety and a lively environment matter, too, but mostly in the sense that their absence may deter people from moving to a centre. A large attraction of moving to a major international financial centre is the sense of "buzz" around it – the sense that this is the place to be, where the best opportunities are to be found, where the most exciting developments are happening.

The size of the local talent pool is partly a matter of history, but it is also shaped by other factors. In highly skilled professions like finance, law and accounting, education, training and qualifications are important. The cities and countries hosting international financial centres are also home to top international universities, which attract the best students from around the world, many of whom join the local labour market. The ability to hire these graduates is an important attraction of these financial centres. Here again, immigration rules are important in permitting international students to become local professionals.

Flexibility of local employment laws is another important factor. Firms are more likely to recruit in a centre where hiring is simple and where it is not too costly or cumbersome to downscale in response to a changing business environment.

Connectivity

Financial centres depend on being well connected, both physically and electronically.

Connected markets

As a financial centre becomes more international, connections between financial market infrastructures, both domestically and internationally, become increasingly important. As noted earlier, traders located in a financial centre may be dealing with markets and counterparties located anywhere in the world. Being connected to markets therefore requires:

- Market data – having real time data from markets within the centre distributed globally and data from world markets available to firms within the centre.
- Order routing systems – technical systems that allow orders to be electronically routed from firms within the centre to firms in overseas markets and vice versa.
- Access to post-trade infrastructure – the ability to clear and settle trades carried out on foreign markets and giving foreign firms the ability to clear and settle trades executed locally.
- Foreign intermediaries setting up branches or appointing agents in the financial centres.
- Local banks building up network of correspondent banks and overseas branches.

Telecoms and internet infrastructure

Financial markets are extremely demanding in terms of the capacity and speed of electronic communications they require. Financial firms expect to receive enormous volumes of price data and expect to measure transmission times for electronic orders in microseconds. Excellent, high speed, low latency and reliable communications to other marketplaces are essential.

High quality international travel links

As financial centres develop, having a major international hub airport within close proximity of the city centre is a very important consideration. The more international the financial centre, the greater the range of routes that it will be expected to offer.

Language

The languages spoken in a financial centre are not an important factor if business is purely domestic. To develop international business, however, English language skills are essential, since this is the international standard for finance business, alongside access to skills in all the languages spoken in the area served in order to communicate well with end clients, in addition to finance professionals.

[2] International Organisation of Securities Commissions – global body of regulators

[3] Committee on Payment and Settlement Solutions – central bankers standards setting body

[4] Bank for International Settlements

[5] International Securities Dealers Association

Critical mass

Mutual trust is the basis for most financial transactions. Knowledge and information are the lifeblood of financial markets. Even with modern technology, it is common for the principal parties to a financial transaction to feel the need to meet and establish a personal relationship before proceeding. The information and knowledge exchanged across the people network within a financial centre can be a potent driver of ideas and market innovation. The result is that a distinguishing feature of financial centres is the concentration of people, firms and activities in one place – intermediaries, such as banks and brokers; investors, such as hedge funds and other asset managers; major corporations; and related professions, such as law, accounting, IT and PR firms.

We refer to this effect as "critical mass", though it is often also described as "clustering" or agglomeration. Once achieved, it becomes self-sustaining, in which the presence of one group of players attracts further players, which attract further players and so on.

Firms offering support services are likely to follow their customers. Just as financial service companies cluster within a financial centre, so there is an incentive for firms that supply support services such as lawyers, accountants, marketing & advertising, IT support etc. to locate close to them. When critical mass is obtained, a financial institution does not have to go far to find a choice of competing firms to meet all of its needs.

Having a concentrated area makes it easier to provide facilities - such as transport, real estate, utilities and telecoms - which meet the specific needs of financial services firms. A visiting customer or counterparty can meet all the relevant financial firms they very efficiently.

6. Conclusions

This paper has identified the key features that financial centres have in common as they develop, as although these should not imply a simple formula for building one, as the growth of a financial centre depends on a complex blend of tangible and intangible factors.

The tangible factors are the ones that can be put in place by government and market participants. These are the factors that give confidence to market participants and that make it a good place to do business: a credible legal and regulatory environment, business-friendly regulations and good infrastructure. Without them no financial centre will prosper.

The intangible factors that help to create a self-sustaining virtuous circle of financial firms, clients and people all wanting to be close to each other and settling on a particular place to do business together include history, location and reputation.

Finally, there is, of course, the market need that is being met. A financial centre may develop to serve a nation, a region or a particular market sector. In the past, this depended on the establishment of particular institutions, such as exchanges or clearing houses. Now, however, when these institutions are almost universal, the emphasis is rather on creating links between market infrastructures. To grow from a domestic to a regional or international centre, the level of connectedness and openness is critical.

From local to global
Building a modern financial centre

SPECIAL INTEREST PAPER CITY OF LONDON CORPORATION

www.cityoflondon.gov.uk/**economicresearch**