HOW THE CITY REALLY WORKS

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3rd edition

The definitive guide to money and investing in London's square mile

Alexander Davidson

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For Acelia, Victoria, Michael, Philip and Eleanor

With love

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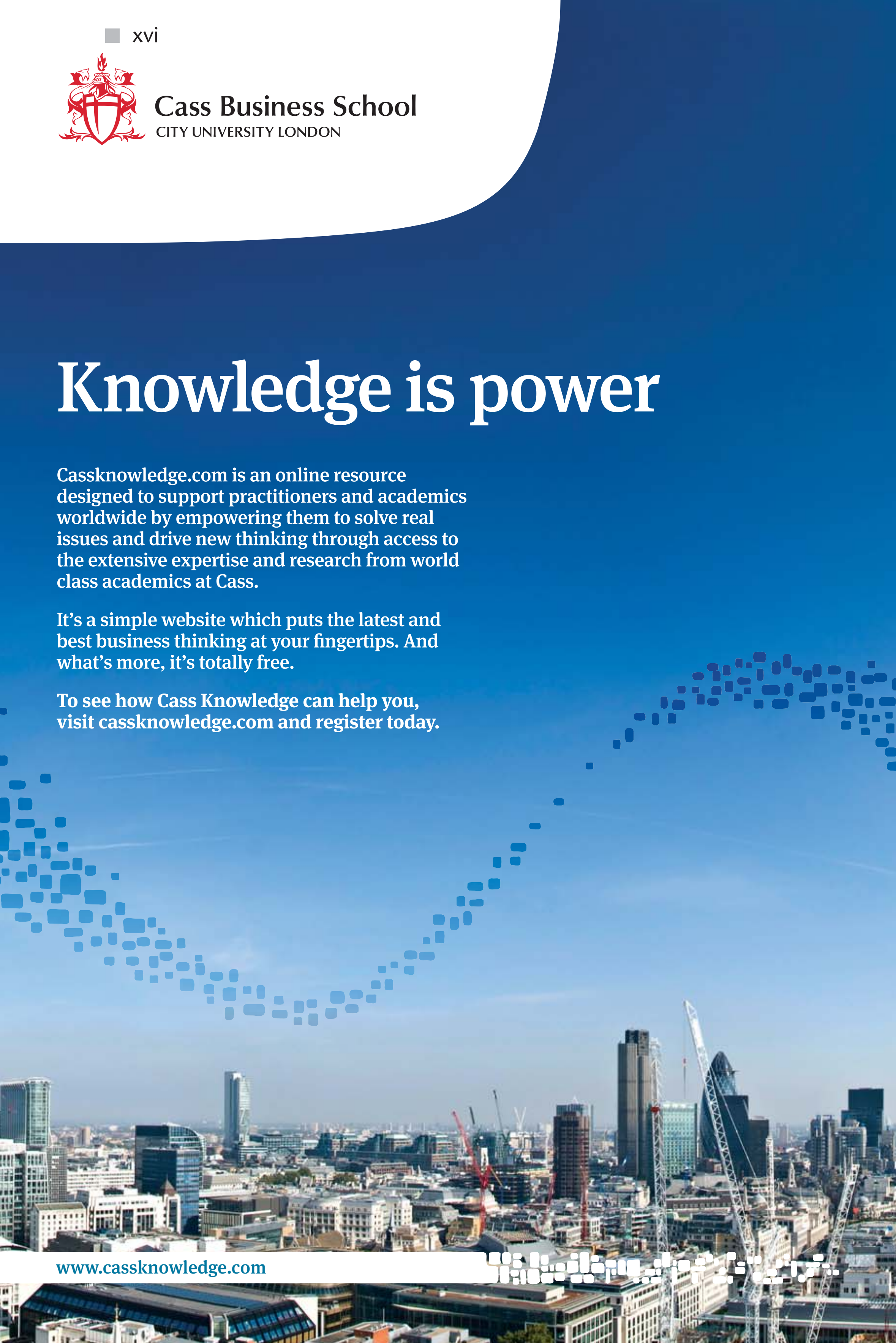
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India and others. Even during recessions, it's a market which continues to power ahead, as witnessed by Kraft's recently agreed takeover of Cadbury. New entrants emerge who want to buy companies: in the 1980s, it was the leverage buyout funds, the 1990s saw more deals that crossed borders internationally and the rise of technology companies doing large deals with overpriced shares, and early in the new millennium it was the hedge funds, private equity firms, and venture capital companies that added volume to an already strong merger wave.

When the economy declines so does the cost of buying companies, this brings further buyers into the market. Sovereign wealth funds from the Middle East and Asia continue to have an appetite for purchasing large stakes in companies and targeting major industries. This is likely to continue - when one player steps off the stage another is ready to come on. The curtain hasn't closed on the M&A deal market.

Looking towards the future of M&A, two things will never change: first, a large number will fail to deliver what the architects of the deal promised, and second, whether the deal is successful or not, people will lose their jobs when companies combine. Many people get fired but many people survive as well. It's also an unfortunate fact that some of the survivors are not the best qualified or most experienced from the wide choice of internal candidates in the pre-merger companies. Politics and luck play roles in who survives, or maybe even an outsider is brought in.

You don't need to leave it all up to chance. There are some tricks of the trade from the hundreds of people interviewed for *Surviving M&A* – all of whom had lived through a takeover. Many, if not almost all, noted that if you want to improve the odds of being retained rather than fired common sense comes into play. Of course general good business practice is necessary, one should be perceived as someone who has a positive attitude about the company and about the specific merger or acquisition underway. Open criticism of the merger process and how management are handling the deal should be avoided.

But these survivors also explained that it is also crucial to be aware that one of the biggest myths during a merger: that those with merit will be recognised and retained. Employees and managers alike falsely assume that if they are better than their peers, this will be noted and they therefore are not at risk of being demoted or made redundant. Nothing could be further from the truth: leaving your corporate future to chance may be the

Reducing the risk factor

By Charles Tilley, Chief Executive, The Chartered Institute of Management Accountants (CIMA)

The world economy may have been pulled back from the brink of collapse but it could be decades before trust in the system is fully restored. The big question now is how do we begin to rebuilt this trust? And more fundamentally, is it possible to prevent corporate greed and short-sightedness in the future?

One of the first steps on the path to improving confidence must be a renewed focus on corporate governance. It has been agreed by many financial experts that regardless of who is to blame, the crisis was unquestionably exacerbated by corporate governance failures. There is particular concern that many of today's risk management processes and systems of governance do not seem to provide a clear method of challenging high risk decision making.

No system is perfect: there will always be people who find a way around the rules. But measures must be put in place to keep excess and undue risk-taking to a minimum. A suggested roadmap has been laid out in the 39 recommendations by Sir David Walker in his recent review on British financial services.

One of the key recommendations in the review is a greater focus on risk. Sir David points out that the fast-changing environment of the global markets requires much more careful management of both known and unknown risk. To support this, he suggests that banks introduce risk committees in addition to the existing audit committees at board level. This, he says, should ensure that sufficient weight is given to emerging risks that are not captured in conventional risk management, control and monitoring processes.

In the international arena, the Organisation for Economic Co-operation and Development has also highlighted the importance of robust risk management from the top down. Moreover, it concludes that board-level engagement on the high-level risk process should be increased - with particular focus on the entity's risk appetite and tolerance. The Walker review further argues for stress testing to ensure that boards understand the circumstances under which the entity would fail and be satisfied with the level of risk mitigation that is built in.

Looking ahead, the best solution may be to change behaviour rather than the law. In the aftershock of Meltdown Monday back in September 2008, stories began to appear in the business pages describing a culture of fear, cults of personality and mercurial leadership at the top of many of the financial institutions which crumbled. For a board to function effectively, Sir David Walker asserts that directors must have the confidence to challenge the status quo and the rationale of the executive.

The chairman of the UK Financial Services Authority, Lord Turner, has also emphasised the importance of banks receiving external challenges to assumptions of conventional wisdom. This is a step forward. But a challenge culture is not easy to define, create or maintain. There is a clear need for a description of what a 'challenge culture' within boards, and beyond, would look like and a map to show how it can be reached.

This underlines the need for behavioural change rather than more regulation. For a board to properly understand risk, integrate it into strategic thinking and demonstrating a rigorous and consistent approach, the emphasis should be on the quality of conversation about risk rather then simply ticking the boxes in a risk framework.

It is CIMA's view that to be effective in the long-term, organisations need to manage risk reliably throughout the business cycle. It is clear that risk management practices became too lax during the boom years. Nowhere was this more apparent than in the financial services sector where misaligned performance incentives and inadequate risk models led to excessive risk taking.

CIMA research has found that organisations tend to oscillate between under-scrutiny in good times and over-scrutiny in bad times. Sustainable performance requires reliable and consistent scrutiny over the long term. To quote Russell Palmer, former Dean of Wharton Business School, 'Greed reflects a failure of leadership; turning your head to ignore the risk because you are making big earnings today certainly shows a lack of leadership.'

To assist companies down the road to better risk management, CIMA has compiled a boardroom leadership model. This outlines the essential factors which combine to achieve board effectiveness. Previous reviews of governance have led to codification of the roles and responsibilities of boards and their committees. But recent events have demonstrated that, while useful, structures and processes have limited benefit. It is the behaviour of the leadership that is fundamentally important.

Having said this, it's also important to keep the structure under review. As a participant in one of our business breakfasts for FTSE350 directors pointed out, a good process can drive good behaviour. This may mean that processes should be reassessed: weak processes can lead to complacency while codification of best practice can set cultural change in motion.

So, while it may not be possible to legislate against greed, processes can be put in place to keep the culture of greed in check. Of course there are other factors to consider as well. It is my personal opinion that the banking sector's controversial bonus culture could be rationalised to encourage a focus on the long-term success of the company rather than the short-term gain of individual employees. Why not insist that a large slice of an individual's bonus is paid in equities and put into their pension? That way, they would have a direct stake in the long-term future of the organisation and would have no choice but to consider its sustainability.

Overall, I would concur with those who believe that bonuses have been too generous and need revision. The success of an individual employee is not the result of their personal skills alone: they have the reputation of the organisation and its wealth behind them. The rewards must therefore be proportionate to long-term input into the success of the company rather than sort-term performance. In short, boards should only celebrate stellar performance once they understand the underlying reasons for it and, more importantly, the long term ramifications for the company and the wider community.

Foreword

Duncan McKenzie, International Financial Services London (IFSL)

The global financial crisis has impacted all financial centres around the world. London, as one of only two truly global centres as well as the hub for financial services in Europe, has been deeply affected by the crisis. Some firms and markets are undergoing major restructuring. In this new edition of *How the City Really Works*, Alexander Davidson brings us up to date on how the diverse markets that make up financial services in London fit together, and how they have fared.

Prospects for some firms and markets in London that were deeply affected by the crisis have been improving. Banks are recapitalising and hedge funds have generated improved returns in 2009 following negative returns and outflows during 2008. Securitisation markets, however, are still largely limited to repurchase schemes operated by central banks, so the primary market for securitisation in Europe remains largely closed. Other sectors, such as insurance, fund management and securities markets, have been less affected by the crisis but have experienced a slowdown or fall in business that might be expected during an economic downturn.

International coordinated action by governments and central banks has staved off the prospect of a 1930s-style recession and helped to rebuild confidence in the global financial system. Downside risks are diminishing but much work remains to be done. IFSL's key priorities for reform of financial regulation at national, EU and global levels include more convergence of the world's regulatory and supervisory regimes; development of market structures that promote competition and openness to international participants; and regulation that blends necessary controls with scope for innovation.

Despite the setbacks and the broad challenges facing the financial sector, London's continuing prospects as the premier financial centre of Europe are underpinned by a number of factors:

- The structural strengths – diversity of markets, strong skills base, global orientation and legal system – that underpin London's status as one of only two global financial centres remain in place.
- Beyond specific challenges in banking, securitisation and hedge funds, financial markets in London have continued to function efficiently and without interruption despite volatility and loss of confidence.
- London once again came top of the rankings in the September 2009 edition of Global Financial Centres Index commissioned every six months by the City of London Corporation.
- Global regulatory reform offers a framework for embedding the lessons of the crisis.

London's position as the premier global financial centre is founded on the transaction of more international business than any other centre worldwide: for example 19 per cent of cross-border bank lending out of London; 36 per cent of foreign exchange trading; and 43 per cent of over-the-counter (OTC) derivatives. In other areas, such as hedge fund assets and private equity investment, the large US domestic market puts New York ahead of London but London – with 18 per cent of global hedge fund assets and 17 per cent of private equity invested – is the leading financial centre by far in Europe.

Professional and other supporting services also play a crucial role in supporting the financial services cluster. International law firms, in particular, have created large international networks which have put three London-based law firms on top globally, facilitated by the widespread use of English law. A friendly legal framework for arbitration and alternative dispute resolution has also contributed to London's status as a major centre for international dispute resolution.

While some of the markets that contribute to the London cluster have long historical origins such as commercial banking, insurance, fund management and maritime services, the cluster has expanded as London has been able to take a lead in many of the new markets that have developed over the past half century. The international bond market put down roots in London in the 1960s, followed by the modern financial derivatives market in the 1970s and hedge funds in the 1990s.

In recent years, London has also taken the lead in developing a fully functioning carbon market, aided by the UK piloting its own emissions trading scheme ahead of the EU. The UK has also stolen a march on other Western countries in developing a nascent market in Islamic finance. The UK has adapted its legal framework so that, from a tax and regulatory perspective, Islamic sharia compliant financial services are treated on the same basis as conventional financial services. London now has far more banks supplying Islamic finance than the rest of western Europe combined.

Implicit to this is the fact that financial services are, above all, about supplying relevant products which meet the requirements of individuals, businesses and other organisations. None of this is to underestimate the domestic and international challenges that lie ahead; these are substantial but can be addressed and resolved. And a key factor in facing up to such challenges is information and understanding how people can become better informed as to the nuances of complicated financial marketplaces such as London, Tokyo and New York. This third edition of *How the City Really Works*, published in association with *The Times*, is an excellent starting point for anyone looking to learn more about the City and the Square Mile, and London's role in international finance. Alexander Davidson has, once again, done an incredible job of distilling a wealth of information into a single publication, and he is to be commended for having done it in a clear, succinct and understandable manner.

Duncan McKenzie
Director of Economics
International Financial Services London

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This book owes much to the City professionals who gave freely of their valuable time to provide interviews, source material and other help. At the same time, the content is independent, and is neither endorsed nor approved by any institutions or individuals named. The selection of facts and themes, and the opinions expressed, are the author's alone.

With this proviso, for the third edition, I received help, in no particular order, from many City institutions, including, but not confined to, the Association of British Insurers, the Association of Chartered Certified Accountants, the Bank of England, the Baltic Exchange, the London Stock Exchange, PLUS Markets, Euroclear, SWIFT, LCH.Clearnet, NYSE Liffe, the Building Societies Association, the London Metal Exchange, FTSE International Limited, Compeer, the Association of Investment Companies, the National Association of Pension Funds and Lloyd's.

Denis Peters, corporate communications director at Euroclear, gave this new edition a full reading. His substantial knowledge of the City and his eye for detail added, as ever, significant value to the text.

I have drawn extensively on research produced by International Financial Services London, which is useful for anybody with an interest in the City. On regulatory issues, I am indebted to the output of the Financial Services Authority in particular. There are City people with whom I talk regularly in my work as a journalist whose insights are reflected in the book, and I would like to thank these professionals. I owe much to organisations such as the Chartered Institute for Securities and Investment and the Chartered Insurance Institute, and to many trade bodies and financial institutions, as well as to the research of academic institutions, particularly Cass Business School.

In the previous editions of this book, I have had significant help from many other institutions including, but not confined to, the Council of Mortgage Lenders, the Asset Based Finance Association (formerly the Factors and Discounters

Association), the Alternative Investment Management Association, the UK Debt Management Office, and the Financial Reporting Council, as well as Equiduct, Chi-X, the International Underwriting Association of London, Equitas, the Department of Work and Pensions, the Pensions Regulator, Deloitte & Touche, Intangible Business, Buchanan Communications, Hill & Knowlton, the Bank for International Settlements, the Assets Recovery Agency, and Intangible Business.

Others that helped include the Finance and Leasing Association, Egg and First Direct, Deutsche Börse, LCH.Clearnet, Euronext.liffe, EDX London, GFI Group and the Association of Private Client Investment Managers and Stockbrokers. ICAP has helped on derivatives, and, through its website resources, on foreign exchange.

Charles Newsome, investment manager at Christows, commented helpfully on earlier editions. Jim Rogers has helped on commodities. Jill Leyland, economic adviser to the World Gold Council, has explained gold markets and Peter Sceats, expert witness and consultant director of business development at TFS London, gave some perspectives.

Anna Bowes at Chase de Vere Financial Solutions, Justin Modray, Kevin Carr of Lifesearch and Tom McPhail, Head of Pensions Research at Hargreaves Lansdown, have helped earlier research on personal finance. The Financial Ombudsman Service has provided insight into its services.

The International Capital Market Association has commented on earlier bonds coverage. Chris Furness, senior currency strategist at 4CAST, gave me insight into foreign exchange. The British Insurance Brokers' Association has always been helpful.

Important note

This book aims to explain the City understandably, using simple language and generic examples. The wording does not have the status of legal definitions, and this guide is for educational purposes. It should not be used as a definitive source, or in particular as a substitute for investment advice. The book is necessarily selective and seeks to cover only the main City activities. It may reflect some of the author's preferences. The City changes quickly and the details in this book may become out of date, but the overview will stay true.

Abbreviations

When I use the name of an organisation for the first time in a chapter, I spell it out in full. Subsequently I abbreviate it. For example, you will find the Financial Services Authority referred to subsequently as the FSA, and the London Stock Exchange as the LSE.

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