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Financial services in Britain's cities: Weathering the storm?*

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Summary

Over the last decade, the Financial and Related Business Services (FRBS) sector has become an increasingly important source of employment in many of Britain's major cities. In Leeds, for example, it provides over 110,000 jobs. This paper suggests that the impact of the global slow down will spread beyond London and the South East to the UK's regional financial centres.

This short introduction sets out a framework for the Centre's future work, which will take an in depth look at the resilience of city economies and offer recommendations as to how the cities may seek to weather the storm.

Introduction

Britain's major financial centres have enjoyed a five-year period of sustained employment growth. Using the ABI's broad definition of "banking, finance and insurance", the number of UK financial services jobs rose by 10.6% in 2003-06. The US sub-prime lending crisis has triggered severe problems in the UK's overextended credit markets.

An IMF report[1] suggests that British banks have suffered aggregate sub-prime related-losses of $40 billon, and could face further losses of over $22 billon. The report also forecasts that total global asset losses could be double those of either the Asian crisis or the dot.com collapse. It is clear the UK's Financial and Related Business Services (FRBS) sector is facing some very stormy waters.

The City itself seems likely to lose as many as 20,000 jobs in 2008, and the major investment banks are already shedding staff. The City, however, has been through this before – both the Asian crisis and dot.com implosion saw job losses which proved to be only short-term. Is the current crisis different in type or scope? Even if the City does eventually weather the storm, is it necessarily the case that the wider UK FRBS sector will fare as well? The UK mortgage market is already contracting rapidly, and elsewhere in the market for consumer financial products, savings are being drawn down on to meet increasing living costs, and credit card debt seems bound to flatten out after recent dramatic growth. All of this would suggest that as the City sneezes, the rest of the UK financial services sector will indeed catch a cold.

This paper advances and discusses the following hypotheses:

- Wholesale market employment will suffer severely but should prove resistant to long-term damage, due to diversification, IT-driven efficiency gains, and outsourcing of non-value-added functions;

**Centre for Cities will be publishing a detailed review of the resilience of the financial services sectors in Britain's cities. If you are interested in being involved in this project please contact, Head of Research, Malcolm Cooper on m.cooper@centreforcities.org*

1 International Monetary Fund (IMF) (2008) Global Financial Stability Report, World Economic and Financial Surveys

- Britain's large retail banks, the largest employers on a country-wide basis, have stretched balance sheets and may pursue significant cost reductions around their regional networks and in their back-office and marketing divisions;
- A decrease in mortgage lending and other retail market products will have the largest negative effect on national distribution networks, the bulk of which are located in regional centres.

Cities which have enjoyed strong recent employment growth need to develop a clear appreciation of the structure of their financial services sectors and seek to reduce their vulnerability to potential job cuts. They will need to pay particular attention to the proportion of marketing and back office support employment.

What is the business structure of financial services?

Like any other sector, the financial services sector is not a homogenous set of activities. In order to understand the impact of a sharp market downturn, it is helpful to understand the basic structure of the sector and how it responds to cost pressures.

Wholesale and Retail Markets

(1) Wholesale Markets

Wholesale markets involve transactions between financial services institutions such as banks, insurers, fund managers and stockbrokers. These are undertaken both for direct profit generation and to provide the financial capability necessary to fund retail market products. The wholesale market operates on a worldwide scale. The businesses tend to concentrate in interrelated clusters which provide the market infrastructure, liquidity and human capital required to operate on a global stage. London is by far the country's leading wholesale market, although strong clusters also exist in Edinburgh and Leeds.

(2) Retail Markets

Retail markets involve transactions between financial services firms and individual customers. The most obvious constituents of the retail sector are the branch networks of banks and building societies. Less obvious are the retail marketing and distribution arms of investment houses, pension funds and insurance companies, most of which now reach their customers via the internet, advertising in the media, or through the branch networks of banks.

The Financial Services Value Chain

Both retail and wholesale markets are built on similar functional models. The best way of understanding these is in terms of the business value chain.

Headquarters Functions

On the face of things, the headquarters function is self explanatory. The reality is slightly more complex. In global wholesale businesses, the ultimate HQ might be in London, New York or Tokyo, but the firms themselves actually operate on a panregional basis, with, for example, all American business being run from New York. Similarly, firms operating in UK retail markets will have a national headquarters, but could be run from regional centres across the country, such as Barclays in Leeds and Lloyd's TSB in Birmingham.

Front-end businesses

Front-end businesses are where most of the value-added is derived. The specific nature of the front-end for an individual business will vary depending on the sub-sector in which it operates. In fund management, for example, the highest value-added function lies with individual fund managers responsible for making asset allocation decisions. In an investment bank, the front-end of the organisation is more complex, comprising client facing research and sales functions, trading desks and corporate finance executives.

Middle and back-office support functions
Middle and back-office functions embrace trade-processing, human resources, logistics and other activities which support primary revenue generation. These services are volume and cost-driven and now tend to be based in decentralised business support centres away from headquarters or customer-facing networks.

Marketing Services
Marketing is a key component of all retail financial services. In the pre-digital age it revolved heavily around proximity to customers and was thus rooted in branch networks. Today the structure is driven by electronic media and supported by contact centres. Significant contact centre clusters exist even in large regional financial centres such as Manchester and Sheffield. Both marketing and back office functions have increasingly been provided off-site. While off-shoring, largely to India, has attracted a great deal of attention, the marketing and support arms of most UK financial services firms are located in British cities, usually outside the high-cost South East.

Market Volumes and Employment
The final and critical dynamic of financial services employment is the direct relationship between the number of jobs and the volume of financial market transactions. While the value of investments or the cost of loans is of critical importance to the individual consumer, it is the number of investment purchases/sales and the number of loans or mortgages taken out by these consumers that determines job gains or losses. The biggest danger to financial services employment is the lack of demand for some financial products and the need to limit the supply of others.

How will the different parts of the sector be affected?
(1) Wholesale markets
The investment banks, the biggest employers in the City and Canary Wharf, have proved very vulnerable to both the US sub-prime crisis and the subsequent credit squeeze. They have also found themselves heavily exposed to over-leveraged hedge funds and most of the larger market participants have been forced to make large writeoffs. The City is already seeing job cuts across the sector. Past experience and market consensus suggest that these may reach the 20,000 mark. Wholesale markets, however, are not suffering across the board, and there will be opportunities to diversify into new products and markets, such as China and India. Employment may begin to recover in 2009, and the damage could be repaired in the following year.

(2) Retail Banking
Britain's retail banks have stretched their balance sheets significantly over the past five years through over-exuberant lending. Most banks will need to shrink their consumer loan portfolios to protect core capital, with the heaviest burden falling on mortgage lending. Reduced lending will have direct negative consequences for bank employment. Banks have already re-structured their branch networks and moved support and contact centre businesses to low-cost regional centres, and these functions are likely to be more vulnerable to job losses.

(3) Other Financial Institutions
While there is no reason to fear for survival of major insurers, pension fund managers or investment houses, all will be affected by falling investment volumes. Job cuts are unlikely to fall heavily on any one group of institutions, but there could be a fairly widespread reduction in staff numbers. These businesses have a very similar support employment profile to the banking sector, and contact centres in particular will experience volume-related job cuts. These should fall across the board, but one should not discount the outright closure of individual support centres.

What will happen in the UK's cities?

The structural dimensions of possible job losses need to be overlaid with city-specific employment patterns. The Annual Business Inquiry and Annual Employment Survey data allows us to look at changes in employment over the period 1991- 2006. The analysis itself covers London, the English Core Cities, and a group of other mid-sized cities with significant financial services sectors – Brighton, Leicester, Norwich and York[2].

Two definitions of the financial services sector are employed. The term 'Core Financial Services' (CFS) refers only to the core sub-sectors undertaking financial intermediation and auxiliary activities (SIC codes 65, 66 and 66). The term 'Financial and Related Business Services' (FRBS), refers to the wider ABI definition, encompassing the core functions and a wider set of activities (SIC codes 70, 71, 72, 73 and 74). While the CFS sector is an important employer in all large UK cities, support services are usually a more significant contributor to overall job numbers.

There are five cities in which CFS employment accounts for more than 5% of total jobs. Of these, London is a global financial centre, while Leeds and Bristol are regional centres with broadly based core services employment. Norwich and Brighton are heavily specialised and fairly dependent on one significant employer (Norwich Union and American Express respectively).

In another group of cities, relatively high FRBS employment is only weakly based on core services. In Birmingham, Manchester, Newcastle, Nottingham and Sheffield, FRBS employment is more than five times CFS employment. Of these, Manchester has FRBS employment well above the national average, while Nottingham has the smallest ratio of CFS to FRBS jobs.

Table 1: Percentage of total employment in 2006

	CFS	**FRBS**
London	7.2%	32.7%
Birmingham	3.3%	18.8%
Bristol	6.9%	26.8%
Leeds	7.4%	26.9%
Liverpool	4.6%	18.4%
Manchester	4.6%	24.4%
Newcastle	3.3%	19.0%
Nottingham	2.7%	22.7%
Sheffield	3.8%	19.4%
Brighton	6.6%	25.9%
Leicester	4.0%	18.8%
Norwich	10.9%	27.9%
York	5.0%	17.3%
Great Britain	**3.9%**	**21.2%**

Source: Annual Business Inquiry

2 Unless otherwise stated we have used the Primary Urban Areas (PUA), in order to best capture the full range of economic activity.

Major employment growth has been in support services
Over the past 15 years the number of employees in CFS has remained relatively constant: in 2006 there were around 1,025,000 people employed in CFS jobs, an increase of only 1% over the previous decade and a half. In contrast, the wider FRBS sector enjoyed 37% aggregate growth over the same 15 year period, reaching its highest level at 5,500,000 jobs in 2006.

This picture is also reflected in cities, though with some interesting variations. Leeds is almost alone in having experienced broad-based CFS employment growth of 59%. Many cities such as Bristol and Brighton actually saw the number of CFS jobs fall.

There are six cities in which aggregate FRBS growth has been near or over 65%, with Nottingham (at over 95%) standing well above Manchester, Sheffield, Leeds, York and Leicester. Manchester currently has the largest FRBS sector outside London employing over 211,000 people in 2006, up by 79% since 1991. Those cities which have experienced a high level of variance in the level of CFS and FRBS growth are likely to be more vulnerable to job losses in the current downturn. In this respect, only Leeds, Liverpool and York appear to be in a strong position.

Growth has often been recent and variable
Some cities have experienced particularly strong growth over the last few years. Nottingham and York stand out in this regard, with jobs growth in the years 2004-6 making up more than 75% of total growth since 1996. For the next four cities - Newcastle, Liverpool, Norwich and London - the comparable percentage is between 25% and 40%. Cities that have experienced recent growth, may find that the jobs created recently are the least secure.

The four larger core cities – Birmingham, Bristol, Leeds and Manchester – have had relatively stable growth trends, when there has been a fall in the level of employment it has tended to be relatively minor and the cities have recovered fairly quickly. The smaller core cities – Liverpool, Newcastle, Nottingham and Sheffield – have experienced a higher degree of variation. So too have the other regional financial services centres. In most cases, these cities have undergone periods of quite significant losses, and periods of sizable growth.

Without a detailed breakdown of employment by employer and job function, it is not wise to read too much into this analysis. It does appear, however, that smaller FRBS centres have an appreciably more volatile employment track record, undoubtedly due to dependence on a relatively smaller number of large employers. This would suggest that such cities might be the most vulnerable in the current credit crisis.

Employment Structure in the Financial Service sector
To produce a more nuanced picture of resilience, we have constructed indices of specialisation within the CFS sector. The degree of specialisation is the ratio of the percentage of people employed in each category in a given city to the national average. The spread of cities across the range of CFS sub-sector specialisation is very uneven. It is significant that only London and Bristol are specialised in four out of the five subsectors, and only these two cities plus Leeds, Brighton and Norwich are significantly specialised in three of the five.

Table 2: Degrees of specialisation within the financial services sector

	Monetary intermediation	Other financial intermediation	Insurance & Pension funding, except compulsory social security	Activities auxiliary to financial intermediation	Activities auxiliary to insurance & pension funding	Financial Service Sector (Overall)
SIC Code	**651**	**652**	**660**	**671**	**672**	**J**
London	1.70	2.28	0.96	3.30	1.59	1.84
Birmingham	0.99	0.56	0.94	0.42	0.90	0.84
Bristol	1.55	0.44	3.65	1.51	1.41	1.76
Leeds	1.79	1.66	3.78	0.96	0.86	1.89
Liverpool	1.03	0.67	2.52	0.81	0.70	1.18
Manchester	0.94	1.18	1.84	0.73	1.61	1.18
Newcastle	1.47	0.35	0.36	0.35	0.39	0.85
Nottingham	0.78	0.39	1.11	0.43	0.32	0.68
Sheffield	1.15	0.63	1.25	0.23	1.01	0.96
Brighton	1.28	3.98	3.04	0.31	0.52	1.69
Leicester	1.58	0.39	0.32	0.52	1.24	1.03
Norwich	0.54	1.76	10.69	0.41	3.22	2.79
York	0.51	0.37	3.56	0.52	2.46	1.28

Source: Annual Business Inquiry

Conclusion

London and the South East are already beginning to suffer from job cuts at the large investment banks. This pain looks set to intensify throughout the current year as businesses re-configure away from loss-making activities. There is some scope for medium term recovery, but the corner is not likely to be turned until 2009 at the earliest. Wholesale market employment models, however, revolve around high level specialisation. They are also more flexible than those in the retail market and are less dependent on dispersed back office support networks.

The UK's retail market centres may be less vulnerable to immediate job cuts, but they are exposed to any systematic rationalisation of dispersed marketing and customer care functions. Larger cities are likely to be partially insulated by the presence of regional headquarters functions and by the relative breadth of their business base. Smaller centres with narrower business bases and low levels of specialisation in core financial services are less well protected. Regional financial centres which have seen employment rise steeply over the last five years of the credit boom could now experience equally dramatic job losses.

UK cities should seek to understand their FRBS sector structure and develop resilience strategies now to prepare for potential future job losses. Close links and an open dialogue with FRBS employers will be vital in this period. While the short-term consequences of such cuts will be negative, the release of skilled workers into the job market may present opportunities for cities to fill skill gaps in other sectors. Similarly, while rationalisation could result in office closures, it could be attended by the relocation of consolidated business divisions to new sites.

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