Chapter 3: The impact of the COVID-19 pandemic on London as a global financial centre

David Chambers
Cambridge Judge Business School
and CEPR

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3.1 Introduction

How will the UK financial sector be affected by the COVID-19 pandemic? And how will these effects interact with those arising from the Brexit process? This chapter argues that the probable impacts of the pandemic and Brexit can best be understood in terms of three factors that have guided the long-run development of the City of London: globalisation, regulation and technology.

There has been a dramatic increase in the size of the financial sector within the overall UK economy since the 1970s. Total bank assets grew from 60% of gross domestic product (GDP) in the 1960s to a peak of over 500% before the 2008 global financial crisis (Davies and Richardson 2010, chart 7). In contrast, US bank assets grew to only 100% of GDP. The difference in the relative size of the two financial systems largely reflects the emergence of the UK — and of the City of London in particular — as the leading global financial centre. When including non-bank financial institutions, the total financial services sector in the UK doubled over the same time period, peaking at 850% of the overall economy measured by gross value added. In the aftermath of the 2008 crisis, the relative importance of the sector has diminished somewhat, due in part to the increased financial regulation to which both banks and other financial institutions have been subjected.

The City of London is a prime example of a successful agglomeration economy (Schenk 2019). Over the long run, the City has benefited from the emergence of a large pool of skilled labour, the pre-eminence of the English language in business, the transparency of the British legal and regulatory system, and London's first-class transport links to other major cities around the world. London's dominant position within the UK financial sector has evolved over the twentieth century, when British banks began to geographically spread across the country. By 1919, the 'big five' banks — Barclays, Lloyds, Midland, National Provincial and Westminster — had emerged following a period of intense merger activity (Turner 2014, ch. 3), and all had their head office in London. In the case of securities trading, activity remained geographically dispersed as late as the 1930s, with over 20 provincial stock markets around the UK (Thomas, 1973). By 1973, only the London Stock Exchange remained. In both banking and securities trading therefore, the dominance of the City of London is primary evidence of just how effectively the considerable gains to clustering in financial services have been exploited (Schenk 2019).[1]

The key findings of this chapter are that over the long run, three factors — globalisation, regulation and technology — have been of overriding importance to the growth of Britain's financial system.

In summary, the contribution of each factor has been as follows:

Globalisation: The history of the UK financial sector can be understood in terms of two inflection points or 'reversals' in the process of financial globalisation — a process which has ebbed and flowed along with the openness of trade and capital flows around the world. The first reversal occurred around 1913 and the decade that followed, when London's capital markets, having grown steadily over the previous century, fell into a prolonged period of relative decline. The second reversal coincided with the reforms introduced by the Thatcher government beginning in 1979, which restored London's capital markets to global pre-eminence. This remains the situation today. As with the 1913 reversal, the City of London again witnessed a decades-long change in its fortunes following the 1979 reversal.

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[1] These same factors, especially regulation and technology, feature in Thomas Philippon's long-run analysis of US industrial competition, including that of the financial sector (see Philippon 2019, ch. 12). Notwithstanding the economic shock of the current COVID-19 pandemic, the same factors remain central to the future of London and the UK as a global financial centre.

Regulation: Regulation has had a major influence on the financial sector over the twentieth century. By the mid-twentieth century, rules and regulations in both banking and securities markets led to a rise in anti-competitive behaviour. Beginning in the early 1970s, a series of deregulatory reforms, first in banking and then in the securities business in the 1980s, stimulated competition both domestically and internationally and helped to rejuvenate the City. Over the last three decades, many regulatory changes have been closely linked to the development of a single market in financial services within the European Union (EU). Being the leading financial centre in Europe, the City of London has been a prime beneficiary of this development. Following Brexit, the UK is now confronted with, on the one hand, the challenges arising from the likely erosion of regulatory 'equivalence' for Britain across the EU's financial markets and, on the other, the promise of pursuing a more independent, regulation-light path, the benefits of which remain uncertain.

Technology: Technological change has been central to the growth of the financial sector, and Britain's economy in particular, since the arrival of the transatlantic cable in the 1860s. The information and communications technology revolution over the last quarter of the twentieth century has played a similar role in facilitating the growth of the financial sector globally, and the City was no exception. At the time of writing, a new technology- (and pandemic-) related question is whether the rise in remote working will reduce the importance of financial centres such as the City of London. Whilst there may be lasting de-agglomeration effects from the change in working practices, these effects will be common to all major city-focused financial centres and as such will most likely not affect the relative competitiveness of the City of London.

Finally, we cannot ignore Brexit. Its consequences remain at least as important as those of the pandemic for the future competitive position of the City of London and its institutions, especially in the context of regulation.

3.2 The roles of globalisation, regulation and technology

Globalisation

The 'Great Reversals' meta-thesis of Rajan and Zingales (2003) argues that there were two major inflection points in global financial development over the last century and a half. These reversals in financial development are strongly correlated with the openness of trade and capital flows in the global economy. As a percentage of GDP, global net capital flows peaked at around 4% in 1913, fell back to 1.5% in the 1930s and then to 1% in the 1960s, before recovering to pre-1913 levels in the years before the 2008 global financial crisis (Capie 2002; IMF 2014).

In large part, the ebb and flow of London as a financial centre broadly fits with this meta-thesis. Britain's leading position in international finance peaked around 1913, though this peak was not obvious at the time. For a decade after the First World War, the government and Britain's major financial institutions lived in the hope – exemplified by sterling's return to the gold standard in 1925 – of reasserting the pre-eminent position of the City. Such hopes were dashed by the banking and currency crises of 1931 and the subsequent slide of the international economy into autarky over the rest of the decade as capital controls were imposed in many countries. The new architecture of international finance negotiated at Bretton Woods in 1944 both confirmed the balkanisation of global capital markets started in the 1930s, and at the same time represented the final eclipse by the United States as global financial hegemon of a war-impoverished Britain.

The removal of exchange controls by the incoming Thatcher government in 1979 triggered the re-emergence of London as a leading global financial centre, alongside New York, in banking, foreign exchange and securities trading. In the latter case, the London Stock Exchange became a major venue for the listing of foreign firms, while both domestic and foreign financial institutions became expert in managing global investment portfolios from a London base. Over the past four decades, modern finance has witnessed a significant transition, with a marked growth in the importance of asset management and of new channels of (household) credit intermediation relative to traditional banking (see Greenwood and Scharfstein 2013 for the United States as the same applies to the UK). This trend reflects the ability of the finance sector to innovate and create new products and services, as well as the response of banks and financial institutions to deregulation.

Regulation

Whilst regulation to improve investor protection and strengthen banking stability is critical for financial development, regulation of the wrong kind can restrict competition in financial services. During the nineteenth and early twentieth centuries, investors were left to their own devices when trading securities; thereafter, successive attempts were made to better protect them. Following successive crises, the position in banking started to improve earlier — during the last quarter of the nineteenth century — largely thanks to the monitoring role played by the Bank of England.

During the early and middle parts of the twentieth century, however, both banking and securities trading displayed a lack of competition in keeping with other industries in Britain. Competition and credit control ushered in by the Bank of England in 1971 ended clearing bank collusion in setting interest rates and nudged banking into a more competitive era. Other landmark deregulation events included the sweeping away of foreign exchange controls in 1979, and the 'Big Bang' in 1986, which ended wide-ranging anti-competitive practices at the London Stock Exchange. The latter removed fixed brokerage commissions and brought a close to the enforced separation of banks, stockbrokers and stockjobbers. This provided a huge stimulus to competition and led to a radical realignment of the major banks and financial institutions as foreign capital flowed into the City of London.

At the time of writing, Brexit is of fundamental importance in determining the future course of financial regulation in the UK. The City benefited enormously from the UK being part of the European single market. By the late 2010s, exports of financial services were six times imports, generating a surplus of £50 billion. Around 40% of this trade was with the EU. Taking the specific example of European share trading, more than 50% was executed in London before Brexit. Immediately after UK financial firms lost blanket access to the EU on 1 January 2021, under the so-called single market passporting regime, London's market share fell to around 25%, a level less than that of Amsterdam (Stafford 2021).

The outcome of ongoing negotiations with the EU over financial regulation remains highly uncertain. A central question is whether the EU will grant regulatory 'equivalence' to the UK financial services sector, or use this opportunity to onshore certain strategic capital market activities by imposing regulations which effectively limit competition from London. An alternative way forward is for the UK to become the 'Singapore of Europe' and pursue a low financial regulation (and low tax) agenda in order to remain globally competitive in attracting business from the rest of the world outside the EU. As with trade, this will almost certainly involve swapping the certainty of a large European market in financial services for less certain but possibly faster-growing markets elsewhere, principally in Asia.

Technology

Advances in information and communication technology have benefited banking and financial services since the nineteenth century. Beginning with communications in the late 1860s, the completion of the transatlantic cable stimulated cross-border securities trading and investment flows, and in the process improved price transparency between the London and New York stock markets (Hoag 2006). In the early twentieth century, the diffusion of the telephone began to improve communication and order flows between London and the provincial stock markets (Michie 2001). Turning to information technology, in the 1970s large banks able to make the necessary upfront capital investment could successfully exploit the economies of scale (and scope) in transaction-intensive areas such as trade execution and post-trade settlement across equity and fixed income securities, derivatives and foreign exchange (see Morrison and Wilhelm 2007 on the transformation of investment banking). In the past two or three decades, information technology has also benefited front-office analysis in credit decision making, securities trading and portfolio management. More recently, the application of machine learning, artificial intelligence and big data analysis to banking and financial services is being widely pursued across the sector (see e.g. Jung et al. 2019).

The strong technological undercurrents influencing finance have been given a boost by the COVID-19 pandemic. The lockdown has led to a further shift of consumer activity online in many businesses, a development which has further strengthened the already dominant position of so-called Big Tech (Facebook, Amazon, Alphabet, etc.). These firms now have an opportunity to exploit this position and to look to disintermediate traditional banking. This possibility is explored further below.

At the same time, the rapid diffusion of cloud-based video conferencing services has accelerated a shift to remote working. This change in the pattern of work may lead to some unravelling of the powerful forces of agglomeration that have been so much in evidence to date in financial services. As we emerge from the pandemic, we may as a result be witnessing a peak in the relative importance of the City of London within the domestic UK economy in terms of output and jobs. However, this new development is not particular to London; it can be imagined that all big cities around the world, and therefore other leading global financial centres, are being affected in a similar way and that their importance within their domestic economies is thereby diluted.

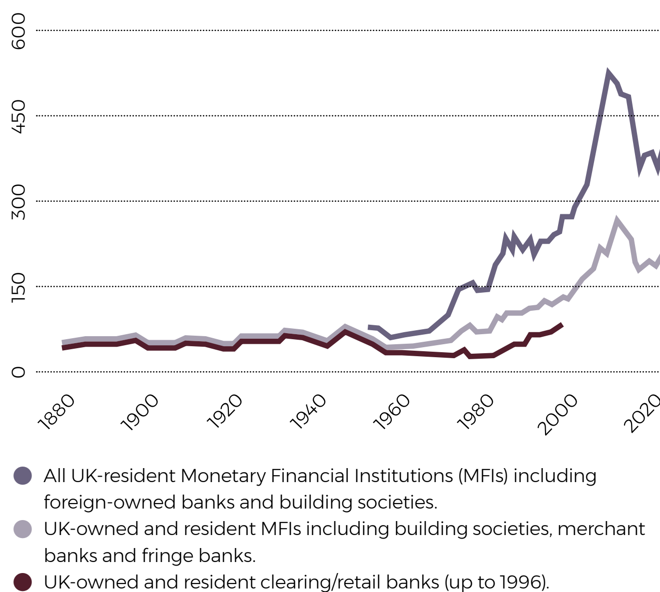
3.3 UK banking before and after the 2008 global financial crisis

The 2008 global financial crisis (GFC) was only the second major banking crisis that Britain has experienced in two centuries. It was devastating in its impact on both financial markets and the real economy in the UK and elsewhere.[2] This section reviews how the interaction of the three factors — globalisation, technology and (de)regulation — has influenced UK banking in the run-up to and the aftermath of this crisis.

Figure 1 shows the long-term growth in the UK banking and finance sector relative to GDP. Until the mid-twentieth century, the UK banking system exhibited steady but modest growth, rising from 50% of GDP in the 1880s to around 80% in the late 1940s. The dark purple line depicts UK retail banks, whilst the light grey line includes building societies, merchant banks and fringe banks. The total-assets-to-GDP ratio for both UK — and foreign-owned banks resident in the UK (dark grey line) starts in 1951 and rises dramatically to peak in excess of 500% just prior to the 2008 GFC. Subsequently, it has fallen back to around 400% as the banking sector has deleveraged. In the 1950s, foreign-owned banks resident in the UK were relatively insignificant, as implied by the difference between the light grey and dark grey lines. From the 1970s onwards, the growth in foreign banks resident in the UK has accounted for the bulk of the rise in the overall bank-assets-to-GDP ratio.

When including non-bank financial institutions, the total financial services sector in the UK doubled over the same time period and peaked at around 850% of the overall economy measured by gross value added.[3] This acceleration in the growth of the financial sector in the UK is broadly consistent with the second reversal in financial globalisation discussed above and the subsequent influx of foreign banks and other financial institutions into London.

Figure 1: UK banking system assets (residency basis), % of GDP



Note: Derivatives recorded on a net accounting basis. Capie and Webber's (1985) deposit data for private banks is used to extrapolate Sheppard's series for private bank assets from 1891 back to 1880. Pre-1920 data includes all Irish banks, after 1920 only Northern Irish banks included. Source: Sheppard (1971); Capie and Webber (1985); Bank of England Statistical Abstracts and Bank of England database https://www.escoe.ac.uk/research/historical-data/money-banking-and-credit

Along with the growth in the importance of banking in the UK economy over the past half century, the sector also witnessed rising concentration, culminating in the largest six banks accounting for 80% of UK customer lending and deposits by the time of the 2008 GFC. In the later decades of the twentieth century, globalisation created abundant opportunities for firms — both domestic and foreign — to diversify their financing away from traditional bank overdrafts and loans into bond and equity finance. Following the opportunity delivered by the Big Bang, commercial banks, both domestic and foreign, met this demand by expanding into securities issuance, underwriting and market-making, and in the process absorbed the majority of independent investment banks to become universal banks.

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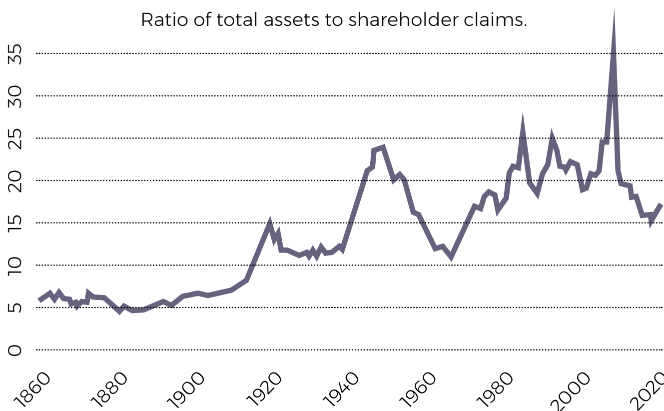
[2] Over the crisis period, bank shares fell 80% in 2007–08. The next worst crises were in 1974, a decline of 63%, and 1931, a decline of 25% (Turner 2014, p.58, Table 3.9).

[3] I am grateful to Ryland Thomas at the Bank of England for providing these figures.

Figure 2: Major UK banks — simple leverage ratio (%)



Source: 1860-1920: Sheppard (1971); Baker and Collins (2003). 1920-68: Billings and Capie (2007). 1969-76: the Wilson Report (1977) and published accounts. 1980-2020: the FPC core indicators derived from published accounts and regulatory returns. The series is based on the core major UK banking groups, using as consistent a peer group of insitutions as possible. The 1860-1920 period has been adjusted upward by 25% based on the hidden capital reserves estimated by Billings and Capie (2012) for the 1920-68 period.

The creation of these very large universal banks resulted in two fundamental and related problems for financial stability in the UK. First, the banks leveraged their balance sheets to a previously unprecedented extent. Figure 2 shows the rising trend in total-assets-to-equity-capital ratio for UK banks, starting from a very modest 5 times in the early 1900s and reaching a peak of around 35 times in 2008. Such unprecedentedly high leverage ratios meant that banks were extremely thinly capitalised going into the 2008 GFC. This leveraging by banks was driven by their management seeking to shift balance sheet risk from shareholders (including, of course, themselves) to depositors (Turner 2014). The surge in leveraging in the decade prior to the GFC was due to the particular unwillingness of bank management and shareholders to adequately capitalise the higher-risk investment banking business independently from the lower-risk commercial banking business. It also reflected how banks were pursuing regulatory arbitrage within the Basel Accord on capital adequacy by shifting their balance sheets towards supposedly lower-risk assets such as residential mortgages (risk-weighted at 50%) rather than higher-risk commercial loans (weighted at 100%).[4]

Second, the existence of these complex mega-banks left the regulators and the government with a 'too-big-to-fail' problem. Bush, Knott and Peacock (2014) emphasise that it is not the size of the banking system in itself but its complexity, the degree of leverage and the uncontrolled asset growth which are critical in undermining financial stability. In other words, there existed an implicit government subsidy deriving from an expectation of the government stepping in and bailing out depositors and other lenders to large banks — 'implicit' in that banks are not explicitly charged for this guarantee by their creditors and the costs of the subsidy are ultimately borne by the taxpayer. This subsidy just after the GFC was substantial. In the case of the UK, it was estimated within a range of $20 billion to $110 billion — larger than the US figure of $15 billion to $70 billion (IMF 2014).

The bank overleveraging problem was addressed in the aftermath of the crisis by a commission of enquiry led by John Vickers. Its final report published at the end of 2013 recommended that the investment and commercial banking businesses be 'ringfenced', and that bank capitalisation ratios be raised (and leverage reduced) substantially (Independent Commission on Banking 2013). At the same time, the UK government has set out to address the 'too-big-to-fail' problem post-crisis by once again tasking the Bank of England with supervising individual banks, including through stress-testing, and with monitoring risks in the entire financial system via the Financial Policy Committee (FPC), established in 2013.

As of today, UK banks are better capitalised than they were a decade ago, as illustrated by the sharp fall in the leverage ratio from 35 times to 15 times (Figure 2). They are also somewhat better regulated, as investment banking activities from January 2019 finally became ringfenced from their commercial banking activities (Proudman 2018). In addition, the previously lightly-regulated shadow banking sector — comprising broker-dealers, securitisation vehicles, finance companies and money market funds — has shrunk by around one-third in the decade post-2008 in response to tighter regulation. With the improvements made in the core banking system, the Bank of England has shifted its focus towards monitoring non-bank financial institutions such as investment funds, pension funds, insurance companies and hedge funds, as these have continued to grow strongly post-crisis to a point where their total assets are now six times those of the shadow banks (Brazier 2018). The investment portfolios of these non-banks represent as much a source of considerable risk to the real economy, both in the UK and globally, as do the balance sheets of more traditional banks. As a result, the Bank of England is interested in understanding how well the portfolios of these institutional investors can withstand systemic risks such as asset firesales and sudden cash calls on derivative positions.

[4] Under the Basel Accord, fully operational from the end of 1992, bank assets were risk-weighted and capital held in varying amounts against those assets depending on the risk weight of each type of asset. Hence, Tier 1 capital ratios of UK banks on the eve of the 2008 GFC were around 8% (Turner, 2014 Table 7.2) and so appeared well in excess of that implied by a leverage ratio of 35 times — a simple ratio which ignores any risk-weighting.

3.4 The City of London post-COVID

The past few years have witnessed the dramatic rise of Big Tech represented by dominant online network firms that can combine e-commerce, payments and social networks into 'payment platforms' (see Brunnermeier 2021).

In the past, the private information that historically accrued to banks via the close monitoring of their customers had great value in their making credit decisions and in cross-selling other products. Today, a firm such as Facebook, which knows almost all there is to know on the spending behaviour of its customers, is in prime position to cross-sell mortgages and other financial products.

As such, the new technology platforms threaten to undermine this information advantage and to disintermediate traditional banks. In addition, the new digital currencies associated with these large payment platforms may lead to payment services being packaged with an array of data services, and in the process further eat away at the information rents of traditional banks (Brunnermeier et al. 2019). Well-known examples include WeChat's and Alipay's digital wallets in China; Facebook's digital currency; and via Libra, a type of 'stable coin' pegged to a basket of official currencies. These platforms represent a potential competitive threat to the traditional banking system — both private and public.

The pandemic itself is unlikely to overturn the fundamental competitive position of the City. Rather, the effects of the pandemic must be understood in terms of how it interacts with the influences which have shaped the City of London over the long run, namely, globalisation, regulation and technological change. One longer-term consequence of the pandemic therefore is the extra impetus given to the shift in the competitive landscape within traditional finance by the rapid adoption of new technology.

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About the author

David Chambers is Invesco Professor in Finance and Co-Founder and Co-Director of the Centre for Endowment Asset Management at Cambridge Judge Business School, Cambridge University, and a Research Fellow of the Centre for Economic Policy Research (CEPR). His research has been published in leading finance and economic history journals and has been covered in the *Financial Times*, *The Wall Street Journal*, *The New York Times*, *The Economist*, *Forbes* and the *Nikkei Shimbun* as well as the BBC and Bloomberg TV. Prior to returning to full-time education in 2001, he worked for 20 years in investment banking in asset management, mergers and acquisitions, and venture capital in Europe, Japan and the United States.