March 2014: An update assessing the current and future contribution of the financial services sector to the UK economy

Where next for UK financial services?

Part 2: Regions of opportunity

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Regions of opportunity

The financial services sector plays a critical role in the UK economy

Where next? The current debate

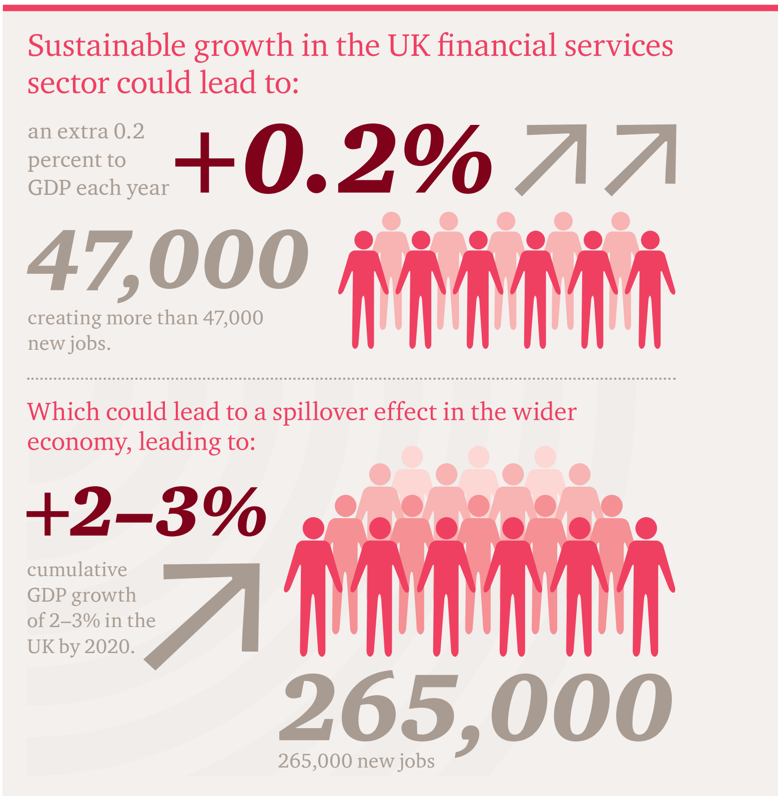
The national debate about the future of the UK financial services (FS) sector is to a large extent polarised, is far from being concluded and features a wide range of stakeholders.

Much of this debate, since the onset of the financial crisis and through the series of scandals and calamities that have followed since, has centred on the risks and costs posed by the sector and the need therefore to contain these risks and recoup these costs.

There is, however, another side to this debate, which needs to be weighed carefully against these risks and costs. In particular, it is crucial that the national strategy for the financial services sector, including that for regulatory and tax instruments, strikes the right balance between, on the one hand, confidence, stability and stakeholder protection, and on the other, efficiency, competitiveness and growth.

As a reminder of this other side to the debate, in July 2013 PwC published a report on the UK FS sector entitled *‘Where next? Assessing the current and future contribution of the financial services sector’*[1]. The report served to re-emphasise that the financial services sector plays a critical role in the UK economy, both directly (as a source of income, employment and tax revenue) and indirectly (by facilitating the efficient provision of credit and other financial goods and services for the benefit of UK businesses and households). It also procures goods and services from other parts of the economy, thereby helping to stimulate them on the demand side as well as the supply side. In these respects, the UK (and London’s) status as a global financial centre makes a significant contribution to the UK’s economic growth and competitiveness.

The *Where next?* report showed that, with a ‘fair wind’ in terms of positive underlying economic growth and a balanced regulatory environment (our relatively benign ‘Scenario 1’), the direct contribution of the UK financial services sector could amount to an extra 0.2 percentage points in GDP growth each year and more than 47,000 new jobs. The indirect spillover to the wider economy could contribute cumulative GDP growth of 2–3% in the UK by 2020, and 265,000 new jobs.



[1] The report can be obtained from our website: http://www.pwc.co.uk/financial-services/publications/where-next-assessing-the-current-and-future-contribution-of-the-uk-financial-services-sector.jhtml

Moreover, although clearly driven largely from London, these benefits would be quite widely dispersed, and not just through the sector's contribution to the national exchequer. While around 50% of UK FS activity is generated from London, the benefits are felt across the whole of the UK. Our July report showed that less than 20% of the 265,000 jobs created by 2020 (in the benign 'Scenario 1' case) would be in London. We believe this is a crucial factor in shaping the ongoing debate and ensuing national strategy through both regulatory and industry channels. So, to help illustrate this point, and to address the popular misconception that the UK financial services sector is really only relevant to London, this update to our July 2013 assessment provides a more detailed examination of the financial services sector's contribution to economic growth across all regions.

Where next? The story so far

To recap, the original *Where next?* report described two possible scenarios for the FS sector in terms of its contribution to the UK economy:

Scenario 1 combined a regulatory regime that facilitates FS sector growth at 75% of its pre-crises level with a benign set of economic conditions. In this scenario, the FS sector grows at a substantial, but sustainable, rate.

Scenario 2, on the other hand, illustrated the dual impact of a more challenging regulatory environment and weaker underlying economic conditions.

In conjunction with this, the report sought to give a sense of the scale of growth the FS sector would need to achieve in order to retain its role as a key driver of the UK's economic performance. It demonstrated that, without substantial FS sector growth over the next decade, the UK economy would need to find major new alternative sources of income.

The original report concluded with the case for a shared strategic vision for the FS sector on the part of policymakers, regulators and the industry itself.

Where next? The case continues

In both the original *Where next?* report and this update, we start with a baseline of the underlying economy, and the FS sector, growing at 1.8%.[2]

In the original report, Scenario 1 is presented as the incremental impact over this baseline.[3] With this update, we have taken Scenario 1 and split out the national (UK level) and regional impacts.

By doing so we aim to illustrate the economic stakes involved – nationally and regionally – in managing and regulating the financial services sector in a balanced and constructive way.

An important inference from this is that these positive impacts could be eroded or even reversed if the UK financial services sector were caused or allowed to underperform relative to, respectively, Scenario 1 or the 1.8% growth baseline.

Modelling approach

We have analysed the economic contribution of the financial services sector through a PwC-developed dynamic economic impact model of the UK economy. For the purposes of this update report we have chosen to illustrate the regional impact of the financial services sector under 'Scenario 1' from our original report.

We present our economic projections at two levels. At the level of the overall economy we focus on GDP, investment, exports and household consumption. At the regional level we focus in on Gross Value Added (GVA[4]).

Analysis is presented as 'net' in the sense that it fully captures the fact that as the FS sector expands, it may divert resources (e.g. skilled labour) from other sectors. The effects of financial sector growth on downstream- and upstream-related businesses are also factored in.

UK level impact

Building on the analysis from the original *Where Next?* report, we present the percentage increases in GDP from Scenario 1 in cash terms. We also break the GDP figure down into some of its different components – exports, investment and household consumption.

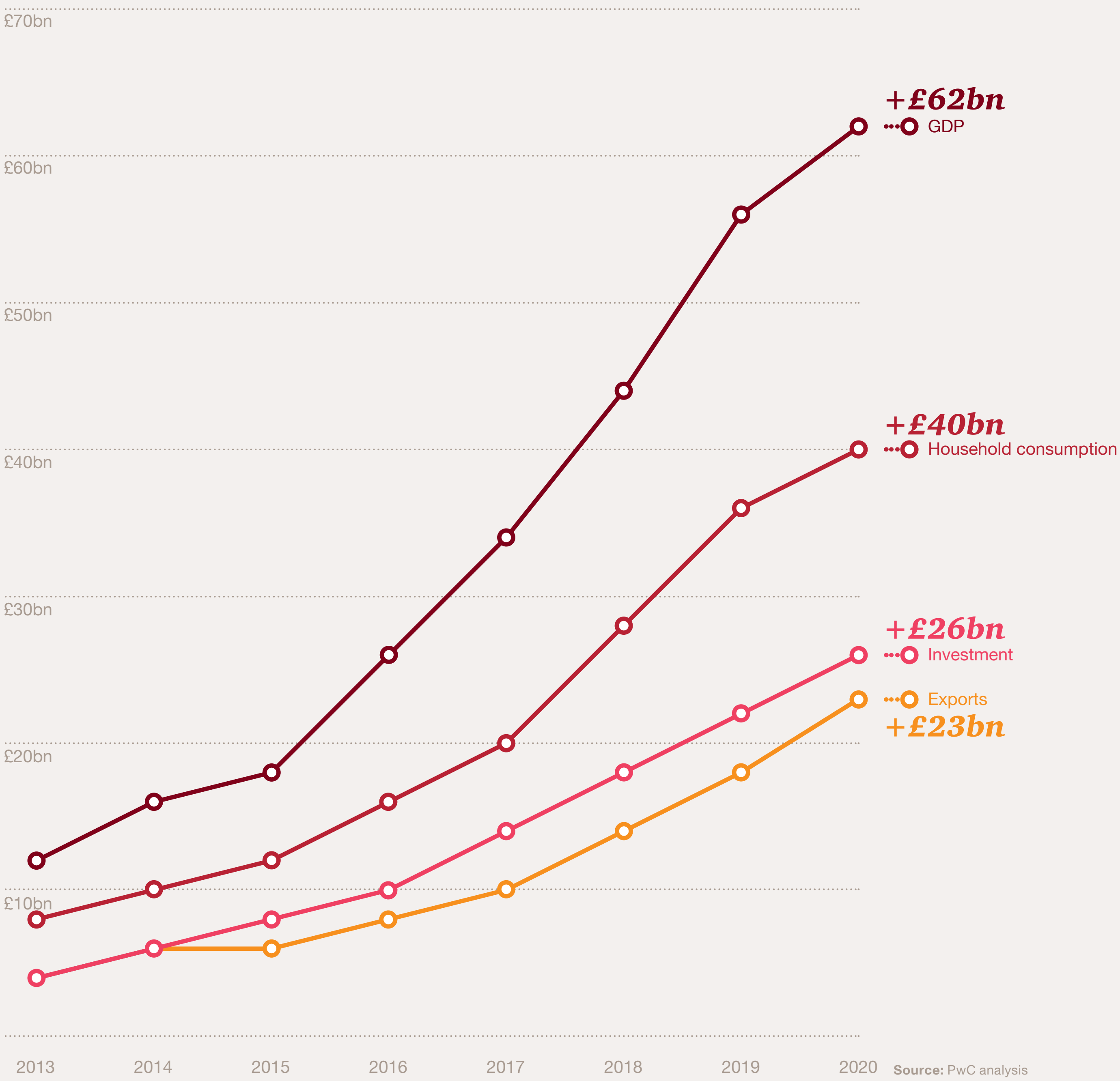
[2] This figure is consistent with the long-term growth rate of the UK economy. In Table 1 of this report we show that the FS sector has been growing at a faster rate than the UK economic average.
[3] A measure of absolute contribution would clearly be much higher, but not very meaningful or helpful to the debate (a zero base – no FS sector at all – is hard to conceive).
[4] GVA is a standard economic measure of sectoral output. It captures the value of goods and services produced in an area, industry or sector of an economy. GVA is the total of all revenues, from final sales and net subsidies, which are incomes into businesses. Those incomes are then used to cover expenses (such as wages and salaries, dividends), savings and taxes. Our regional GVA data are sourced from the ONS Annual Business Survey (ABS) for 2010. Our definition of the FS sector includes: finance and banking, insurance and auxiliary financial services.

Our results suggest that there is potential for an extra £62 billion of GDP for the whole economy to be created through a well-functioning financial services sector by 2020. These GDP gains translate into an extra £26bn of investment and £23bn of exports. Household consumption could gain by as much as £40bn by 2020; in today's money, this would translate into an extra £1,600 per UK household.

The exports generated by the FS sector are critical for the growth of the UK economy. The UK has a trade surplus in financial and insurance activities and this surplus has remained at around 3% of GDP despite the financial crisis.

Figure 1

Extra GDP generated under Scenario 1 (£billions)



Source: PwC analysis

Regional impact

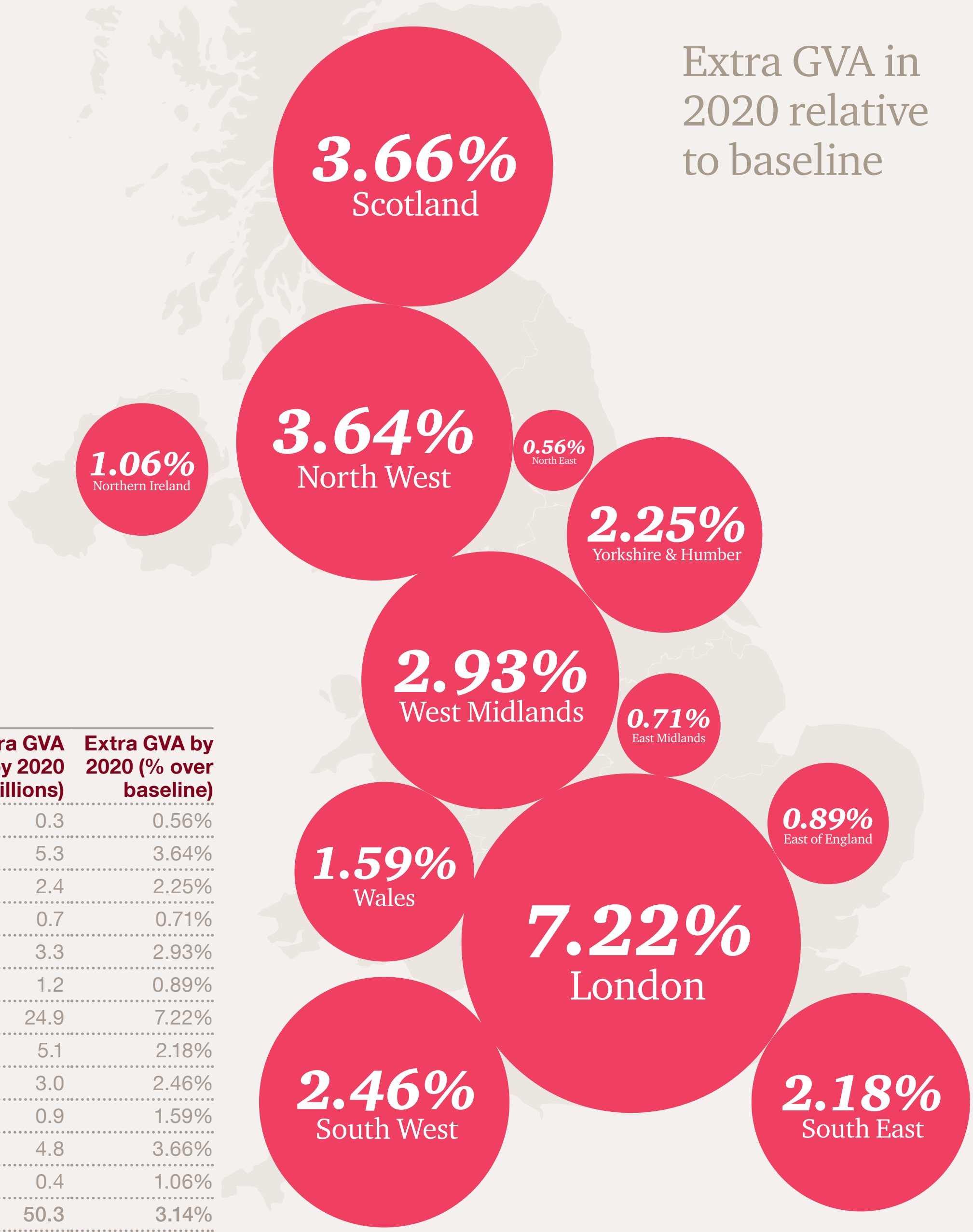
In this report we drill down into the sector's regional economic contribution to provide further insight as to its benefit to the UK economy. Our results from Scenario 1 suggest that all UK regions would gain from having a well-managed and well-regulated FS sector. Putting London's hub status aside, in percentage terms, the Scottish FS sector would contribute the most to GVA growth, followed by the North West and West Midlands. Outside London, the North West contributes the most in absolute GVA terms.

Key regional factors driving our results

The gains observed in London are driven by its status as the largest European financial hub. London generates almost half of all FS activity in the UK and our scenario suggests that this share will fall slightly. While overall growth is stronger in London, much of this is expected to come from exports which, while they do not have as strong spillover effects associated with them, they do contribute to the UK's balance of payments.

Figure 2

Extra, real GVA generated under scenario 1 by UK region (£billions, 2013 prices)



GVA by region	Extra GVA by 2020 (£ billions)	Extra GVA by 2020 (% over baseline)
North East	0.3	0.56%
North West	5.3	3.64%
Yorkshire and The Humber	2.4	2.25%
East Midlands	0.7	0.71%
West Midlands	3.3	2.93%
East of England	1.2	0.89%
London	24.9	7.22%
South East	5.1	2.18%
South West	3.0	2.46%
Wales	0.9	1.59%
Scotland	4.8	3.66%
Northern Ireland	0.4	1.06%
UK	50.3	3.14%

Source: PwC analysis
Note: This table presents the economic contribution of the FS sector in the form of GVA (total UK value £50.3bn). Figure 1 presents GDP of £62bn at the UK level. GVA is subcomponent of GDP and the main difference between the two measures is taxes on production, which is essentially business rates, which we do not estimate for the purpose of this analysis.

London's status as the leading global financial services hub has clear benefits for the wider UK economy.

Benefits of having a sustainable and well-regulated financial hub in London include:

1. The FS sector contributes a greater share of overall tax revenues than its equivalent contribution to GDP – meaning that it has an above average effective tax rate. A large proportion of this tax revenue is attributed to the high value added activities associated with the City of London. In 2013 the FS sector as a whole contributed £65bn to the UK exchequer (11.7% of total tax receipts).

2. Having a world-class financial centre in the UK leads to spillover benefits for the wider UK economy.

3. A growing proportion of London-based activity is being moved out to the UK regions. If exports are separated out from our analysis, Scotland and the North West are growing more rapidly than London.

The strongest growth outside London is observed in Scotland (3.66% more GVA over and above our baseline growth rate of 1.8% per annum by 2020). Scotland plays a critical role in serving the UK market in asset management and insurance and some of the largest UK providers are based in Scotland.

Our analysis has been based on the scenario of Scotland remaining within the UK and therefore continuing to be an integral part of the UK economy. In the event that Scotland elects to become independent, there will likely be implications for its, and the residual UK's, FS sectors. We have not sought to examine these implications as part of this exercise.[6]

The North West also experiences significant growth (3.64% above UK baseline growth). This is because it has a sector with strong technical capabilities and a diverse base of FS firms (including head office functions, specialist back office functions and regional HQs of major UK banks).

The West Midlands also performs strongly (growth of 2.93% above UK baseline). There are more than 1,900 FS-related firms in Birmingham alone; more than 90% of these are SMEs that provide it with a strong and diverse basis for future economic growth.

The South West houses the back-office functions of a diverse range of businesses (particularly building societies and insurers). It is also one of the wealthier regions of the UK and has a relatively large broking industry. Our Scenario 1 suggests it will grow by 2.46% above UK baseline by 2020.

Our modelling suggests that Yorkshire and the Humber will gain an extra £2.4bn per annum in 2020 (equivalent to 2.25% above baseline). This represents a valuable contribution to one of the poorest regions in the UK.

The South East could generate an extra £5.1bn in its level of income by 2020 (2.18% above baseline growth). This would be equivalent to around £640 per person. While this increase in income is impressive, its performance is less strong than other regions. A larger proportion of this region's output is made up of back-office functions that are less well remunerated but perhaps more resilient than other parts of the FS sector.

Of the regions with the smaller FS sectors, Wales (1.59%) and Northern Ireland (1.06%) perform best. The FS sector has grown rapidly in Wales in the past decade, with job creation increasing by more than 60% in Cardiff, which is faster than any other UK city.[5] The same is true, albeit to a lesser extent, in Northern Ireland, where the cost base for FS businesses is lower, which supports a highly productive and diverse sector covering FS software development, risk management functions, administration and operations.

The East of England (0.89% above baseline), East Midlands (0.71% above baseline) and the North East (0.56% above baseline) perform less well than some other regions. We would expect the East of England to benefit due to its geographical proximity to London but it loses out as it is less diverse than some other regions.

[5] http://www.wales.com/en/content/cms/english/business/business_sectors/financial_services/financial_services.aspx
[6] In the event of a vote for independence in September 2014, several important uncertainties will arise which might impact on the performance of the FS sector in Scotland. These include the question of what currency would be used in Scotland and also the regulatory and tax regimes that would be adopted by an independent Scottish government. These matters could be clarified before independence in 2016 but a period of uncertainty would inevitably have an effect on the sector. If independence were not the route chosen by the Scottish people, further devolution, for example of certain fiscal powers, is also possible. It is not possible to say at this stage whether those changes would be beneficial or not, but any changes across the UK (not just in Scotland) arising from further devolution may impact on the spread of financial services organisations across the regions.

Direct versus indirect impacts

As described above, the FS sector can benefit the economy both directly (as a source of income, employment and tax revenue) and indirectly (by facilitating the efficient provision of credit and other financial goods and services for the benefit of UK businesses and households).[7]

To gain a better understanding of direct and indirect effects, we examine the multiplier effects associated with a change in FS sector output. When we refer to multiplier effects we are talking about the trigger effect that results from FS sector growth causing growth in other non-FS sectors. The multiplier effect consists of the indirect effects described above, and an additional induced effect attributable to the spending by FS sector employees in other parts of the economy (food shopping, clothing purchases, etc.). The indirect and induced effects are all part of the overall benefit of having a well-functioning FS sector.

A typical depiction of the multiplier is to say that, for every £1 the FS sector expands by, the whole UK economy expands by £Y's. We report the multipliers from Scenario 1 in Figure 3 below.[8] The results suggest that in 2014, for every £1 of FS sector growth in London, the London economy would grow by £1.46p, while the figure for outside London is £1.43p. Differences between London and the rest of the UK are not substantial.

However, when the balance of direct and indirect effects is taken into account the story changes somewhat. Figure 3 shows that in 2014, the direct effect of an extra £1 of economic activity generated by a well-functioning FS sector leads to a net gain of 64p for the London economy. This figure is significant, because this is a pure additional gain and factors in the opportunity cost.[9] The figure for outside London is smaller at 0.52p – this figure reflects the generally lower salaries paid to non-London FS workers.

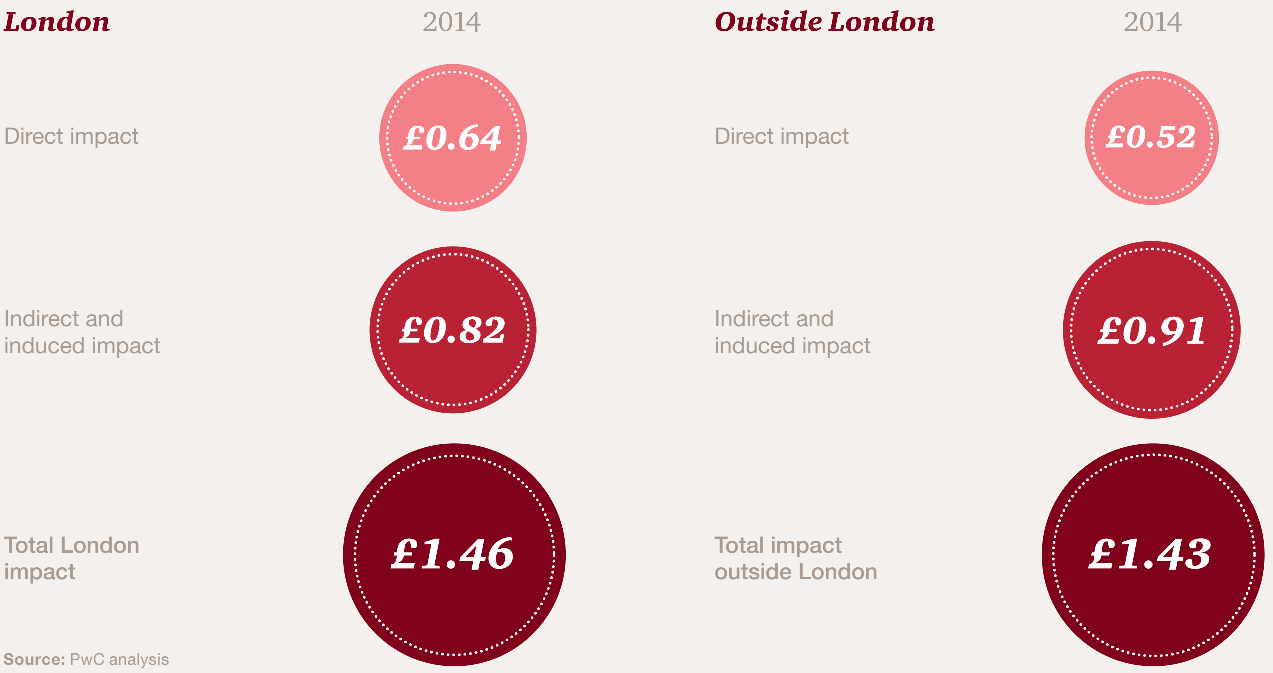
When the indirect and induced impacts are compared, the balance of impacts between London and the rest of the UK changes. In the Rest of the UK, the indirect multiplier is 0.91p; the equivalent figure for London is 0.82p. This result suggests that there is significant gain to be had for the UK economy from encouraging the dissemination of economic benefits outside London; capturing the higher indirect and induced benefits without diminishing the existing direct benefits currently generated in London.

These benefits could be achieved through relocating back office and support services, and so on, which would align with the industry's own agenda of reducing cost, upgrading technologies and better connecting with customers.

[7] See for example IMF *World Economic Outlook 2013*, Chapter 3 for a discussion of spillover effects from the financial sector.
[8] The multipliers that we estimate in this analysis are 'net' rather than gross. This means in addition to the indirect and induced effects we 'net off' the opportunity cost financial sector expansion – these effects are numerous; one example would be if the FS sector grows and recruits a new employee, this would prevent them from working in another part of the economy, so our multiplier only measures the net additional benefit of their working in the FS sector. All sectors will have these types of opportunity costs when expanding.
[9] As referenced earlier, the opportunity cost refers to the FS sector expanding which may attract resources from other sectors (e.g. skilled labour).

Figure 3

Net economic multipliers – a comparison of direct and indirect effects inside and outside London, Scenario 1

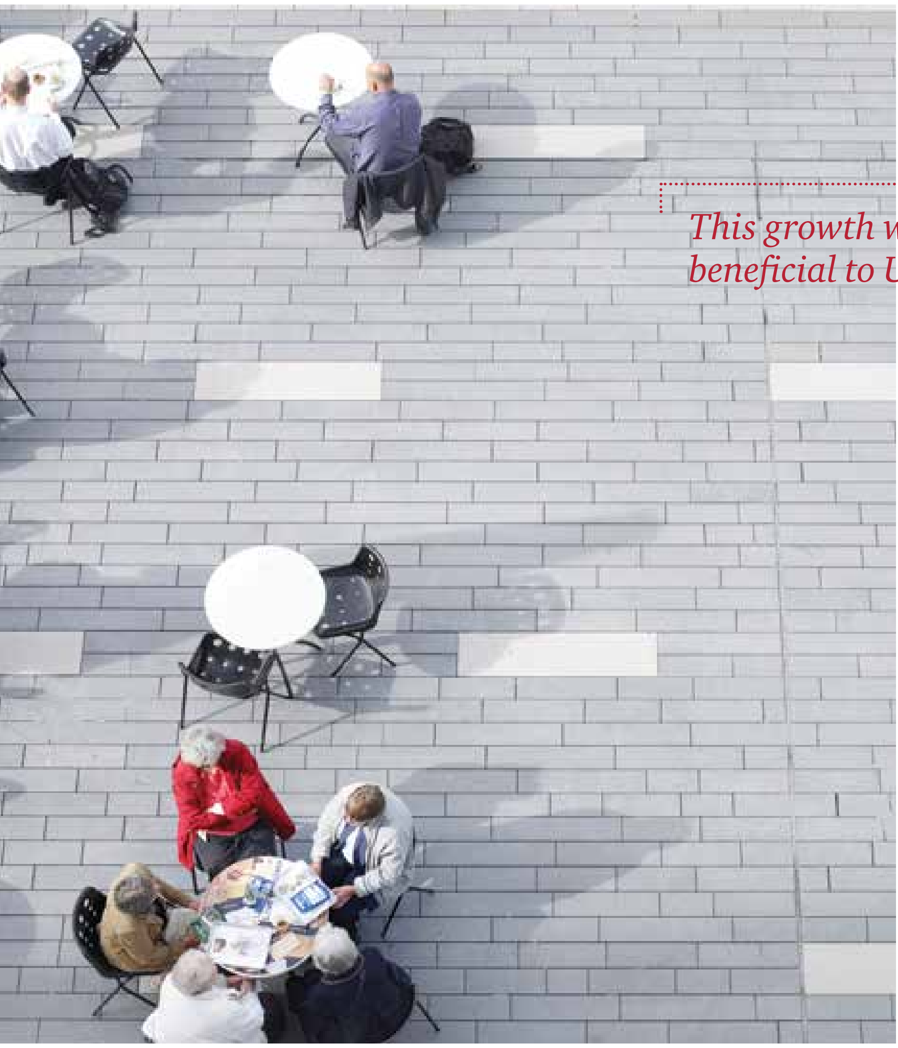


Source: PwC analysis

Implications for the FS sector

The strong links between the FS sector and the wider economy mean that it has a disproportionate impact on GDP growth relative to other sectors of the economy. This is a pattern observed in virtually all economies and is recognised in academic literature (see Aghion et al. 2004[10]). Specifically to the UK, our analysis emphasises the importance of ensuring that the national strategy for financial services in the UK should be aimed at securing this benefit in a sustainable way and, in particular, not threatening the UK and particularly London's status in the global financial services industry. A better financial services sector, rather than a smaller (or even just safer) financial services sector, should be the aim.

The report shows that a combination of a regulatory regime that facilitates sustained FS sector growth coupled with benign economic conditions can lead to net additional gains to UK GDP in the order of £62bn by 2020. This growth will both be driven by and prove beneficial to UK regions outside the City of London.



This growth will both be driven by and prove beneficial to UK regions outside the City of London

[10] Aghion, Philippe, Peter Howitt and David Mayer-Foulkes. *'The Effect Of Financial Development On Convergence: Theory And Evidence,'* Quarterly Journal of Economics, 2005, v120 (1 Feb), 173–222.

Our scenario also shows that the regions of Scotland, the North West and the West Midlands could substantially increase their share of UK FS activity, while FS growth could provide additional new jobs in regions such as the North East where economic performance is less strong.

A key point emerging from our analysis is that the secondary benefits (such as the provision of loans to businesses and households) that accrue to the UK economy from FS sector activity are larger in the non-London regions than in the City of London financial hub. The analysis also implies that if the activity of the FS sector is spread more evenly across the UK, this will perpetuate the benefits of the sector by creating new jobs and employment and a larger market to which the FS sector can provide services.

A more regionally dispersed financial sector could have implications for business strategy in terms of how the FS sector actually connects with its clients and users of FS products. There may be a greater role for digital products that can facilitate this interface. An increasing critical mass of FS skills in non-London regions could also facilitate further movement of key services away from the central hub, which in turn could facilitate an even greater spread of benefits across the UK.

Implications for policymakers

The key challenge for policymakers will be to implement a regulatory framework that helps retain London's status as the world-leading financial hub, but also insulates the wider economy from adverse financial shocks.

In addition to this, policymakers should provide more inducement for the sector to regionalise aspects of their operations that are more labour and infrastructure intensive and also to regionalise their service provision to SMEs and household customers. The industry has itself taken considerable steps to do this, but increased support from policymakers could help accelerate this process.

How the FS sector reacts to new policy incentives will very much be determined by the economic environment and the scope and incentives attached to the new regulatory measures that have been designed to limit the impact of any future financial crises.

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