Judging Destinations

With an ever-increasing number of global destinations offering apparently attractive packages to financial institutions, choosing the one providing the best environment is becoming ever more complex. **Marc Miles, Jack Anderson** and **Michael Segalla** explain how senior executives can judge the conflicting claims.

Deciding which location is right for their needs is becoming ever more complex for the leaders of financial services businesses. It is hard enough for investment managers to sort through all the smoke and noise of competing claims by financial centres and by local and national governments, let alone assess the rapidly changing tax and regulatory environment.

There is, though, a way to do this scientifically and rationally by using a location decision matrix, which incorporates key factors into location decisions in a dynamic and changing world. The matrix creates an organised decision process and a logical progression which makes it easy to compare the relative strengths of potential locations.

One critical element of this process is a comparison of tax and governance, as well as the regulatory and legal environments and the macro-economic conditions – and this process requires not only defining decision factors, but

also looking at specific destinations.

We are assessing ten financial destinations, which include more traditional destinations such as the United States, the United Kingdom, Ireland, Luxembourg and Hong Kong as well as increasingly important sites like Singapore, the United Arab Emirates, Qatar, Bahrain and Saudi Arabia.

The desire of the financial centres in Asia and the Middle East to become major players in the global financial market is well known. While some may question the inclusion of all these newer locations, the recent financial plight created by sub-prime investment vehicles emphasises the importance of these newer financial locations not only as a source of funds, but as locations where decisions are made and money managed.

Financial institutions, reeling from tens of billions of dollars of shaky investment vehicle write-offs, were forced to put out a call to world markets for new capital to bolster their balance sheets and permit continued lending. That call was answered largely by individual investors or sovereign wealth funds of the countries of the new financial centres.

Recipients of capital injections to weather this financial storm included Citigroup (Saudi Prince Al Waleed bin Talal and the sovereign wealth funds of Singapore, Kuwait, and Abu Dhabi plus Sandy Weill and The New Jersey Division of Investment); Merrill Lynch (sovereign wealth funds from Singapore, Korea, and Kuwait plus private investors such as Mizuho Corporate Bank of Japan and The New Jersey Division of Investment); Barclays (China Development Bank and Singapore's Tamasek); UBS (Government of Singapore Investment Corporation and a Saudi Arabian investor); and Morgan Stanley (China Investment Corporation).

In comparing the relative attractiveness of old and new financial centres, managers should rely on the tried and true method of computing the risks and rewards associated with each factor across targeted destinations. For example, existing country specific costs such as tax rates on different forms of profit are known. Given the global market, whichever financial centre is chosen, the investments and their gross returns are likely to be the same for the firm. What will differ are the costs of real estate, employees, other support services and payroll taxes. So the net profit for a given investment can be easily computed for each potential location.

Armed with information on the tax code, partners can figure out how much of that profit actually ends up in their pockets. But what if those taxes change? Recent threats by the US Congress to raise tax rates on carried interest, and the UK's April increase in capital gain taxes and taxes on "non-domiciled" foreigners, have driven home the fact that today's calculation may not be permanent. So, along with the existing tax rates, managers must assess how likely those rates are to move. Favourable changes are an upside risk, unfavourable a downside risk.

Regulation presents a similar set of risks and returns. Regulatory compliance represents a cost of doing business, an indirect tax. In the financial world, regulations could include requirements of registering all offerings, of supplying the government with monthly or quarterly lists of securities traded, of revealing destinations of private investments, or of transparent public accounting. The more numerous or more detailed the requirements, the greater the time and effort needed to meet them. Again, a quick calculation of the employee and support costs associated with regulatory compliance indicates how these rules affect the bottom line.

However, these calculations can suddenly change. The Enron and WorldCom scandals in the United States led to rocketing compliance costs. The resulting Sarbanes-Oxley law truly became a full-employment act for accountants. Alternative investment managers wasted no time in finding new locations that sheltered them from the onerous regulatory impact. On the other hand, the SEC's more recent willingness to follow principles instead of rules and to accept standard foreign accounting systems in place of FASB-consistent bookkeeping promises to offset some of this cost – thereby making New York a more attractive place to do business.

Other countries focus their regulatory efforts on restricting capital flowing in or out of the country. There may be concerns about the impact of inflows on currency or foreign ownership of local companies. There may be a desire to encourage local businesses to invest domestically rather than buying foreign assets. Such barriers directly impede the ease with which alternative investors can react to sudden changes in global market conditions.

Equally important is the legal environment. How strong is the rule of law? How dependable are agreements? Is the judiciary independent of the government? Can courts be counted on to enforce contracts and carry out their judgments? How transparent is the government? Are all subject to

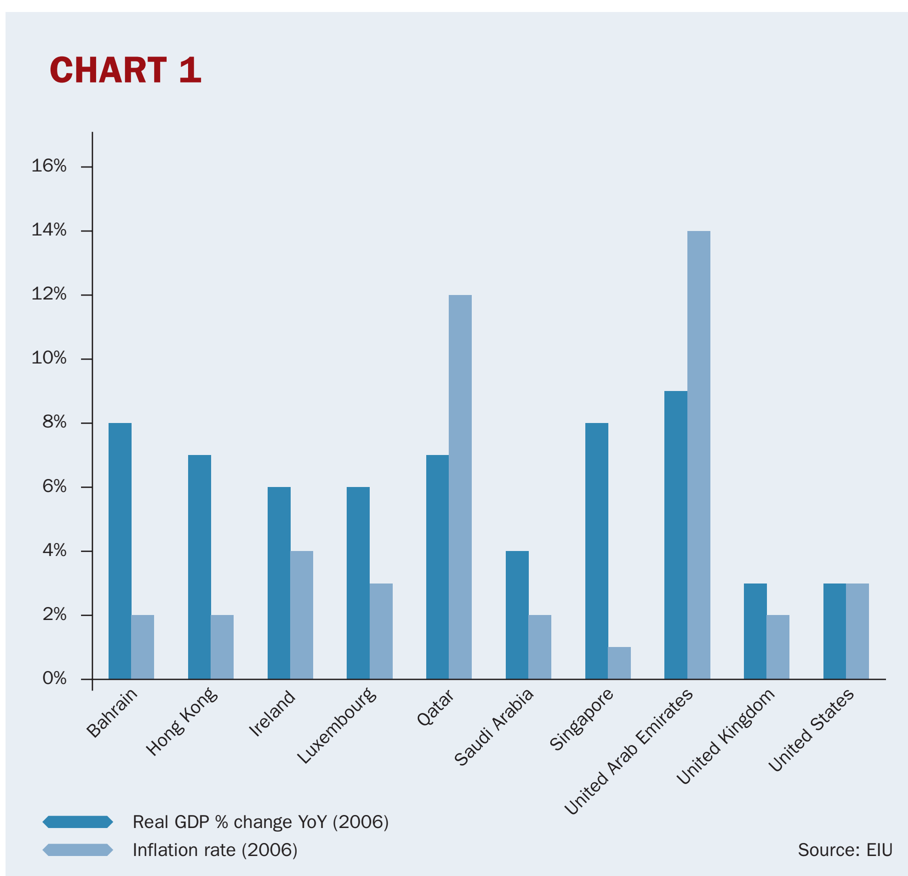
the securities regulations, or does the government play favourites? Do all abide by local rules and regulations, or do some circumvent through payment of bribes? How transparent are securities regulations and transactions? The stronger the rule of law and the more transparent the laws and government, the less likely an investment manager will experience an unfortunate surprise.

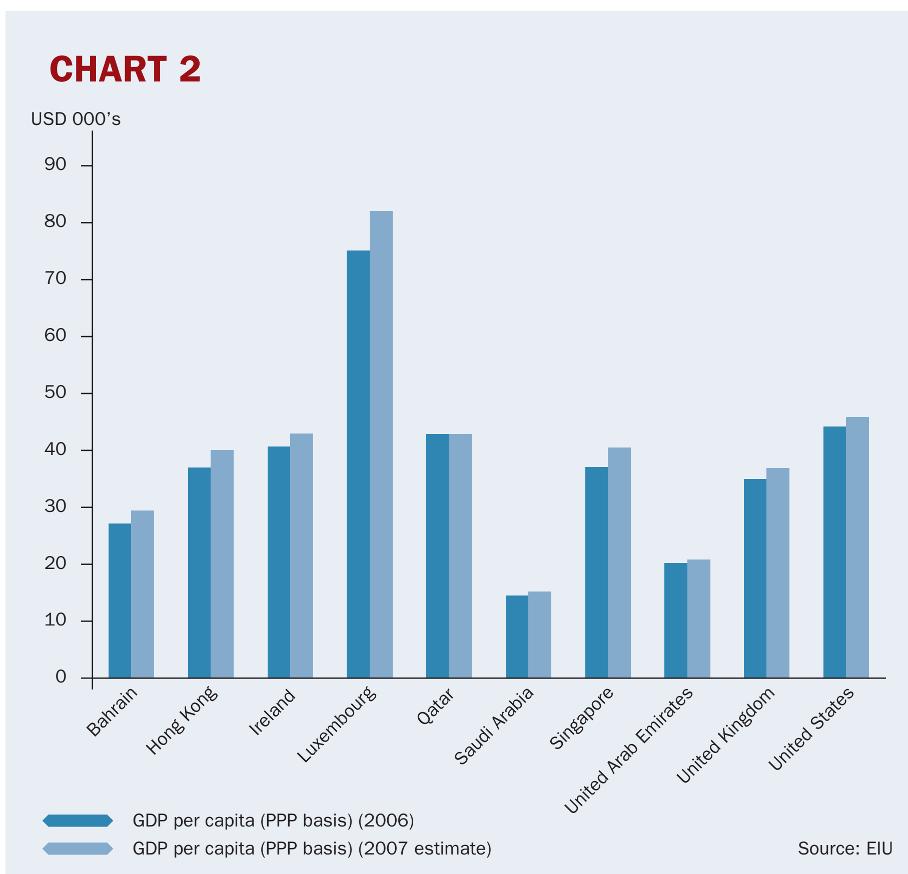
The macroeconomic environment of course includes the risk of tax changes. Positive changes include the willingness of local authorities to provide tax breaks, and investment in infrastructure or other subsidies to attract financial managers and other businesses. But asset values and accounting can be undercut by other factors. A weak currency, or a peg to a declining currency, is associated with rising inflation that can eat into the real value of assets, particularly domestic investments. A flagging local economy reduces the near-term payoff on local investments. Fears of a weak global economy may make marginal or newer markets suddenly seem more risky.

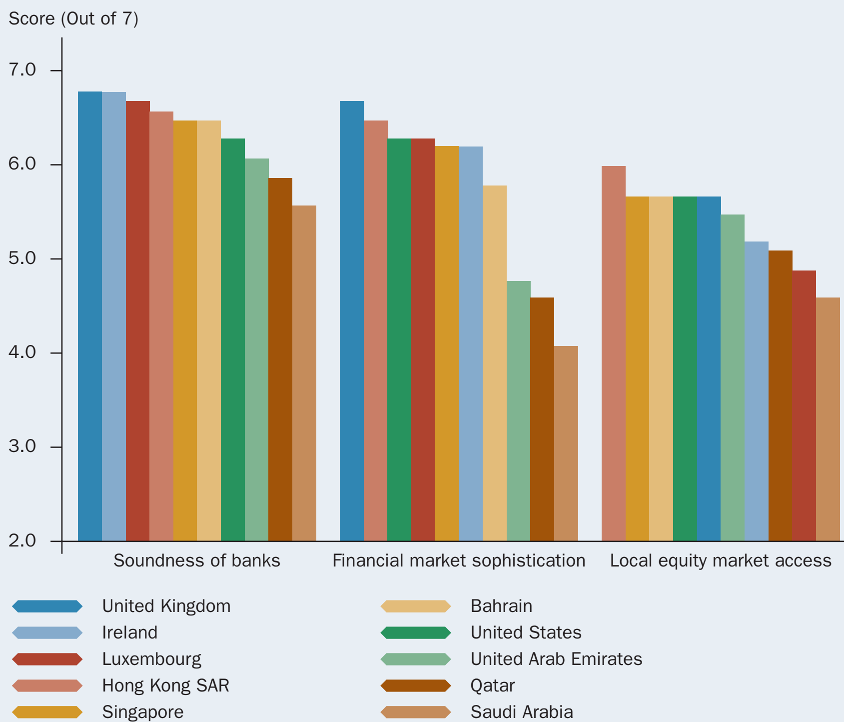
So how do these key factors differ in the ten locations we consider? Our comparison data comes primarily from two independent sources, World Economic Forum Global Competitiveness Report 2007-2008 and Forbes magazines' Global Tax Misery Index. Together they provide initial answers through the location decision matrix. Note that the scale in the charts is from 1, low, to 7 high, in terms of levels of attractiveness for managers analysing the relative benefits of locations.

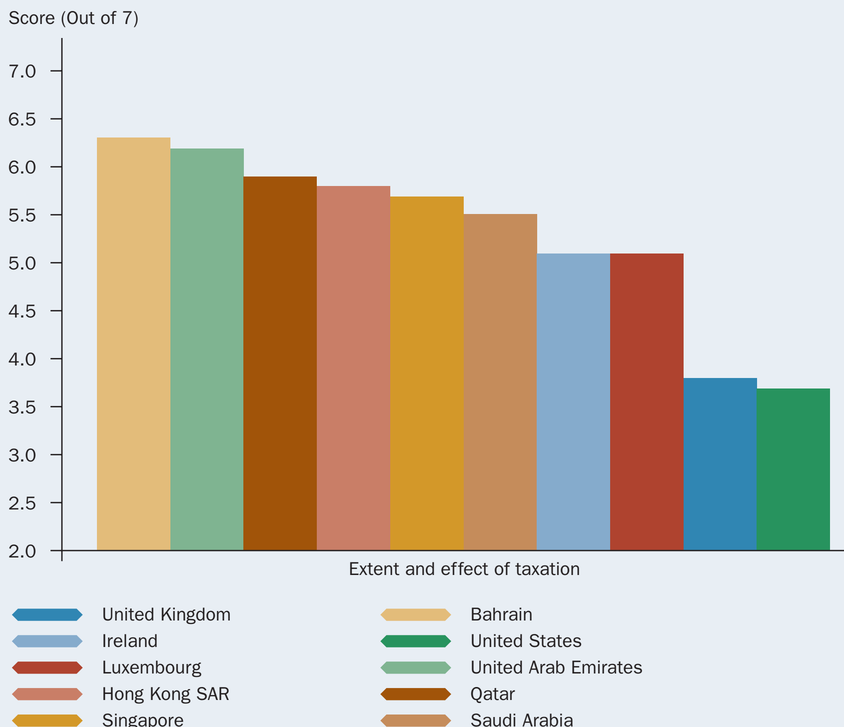
MACROECONOMIC

The macroeconomic environment demonstrates why we have included









the new financial centres (Chart 1 and 2). With moderate inflation, high growth rates and high GDP per capita, the new entrants compare favourably with the traditional locations in the US and the UK.

FINANCIAL MARKET FACTORS

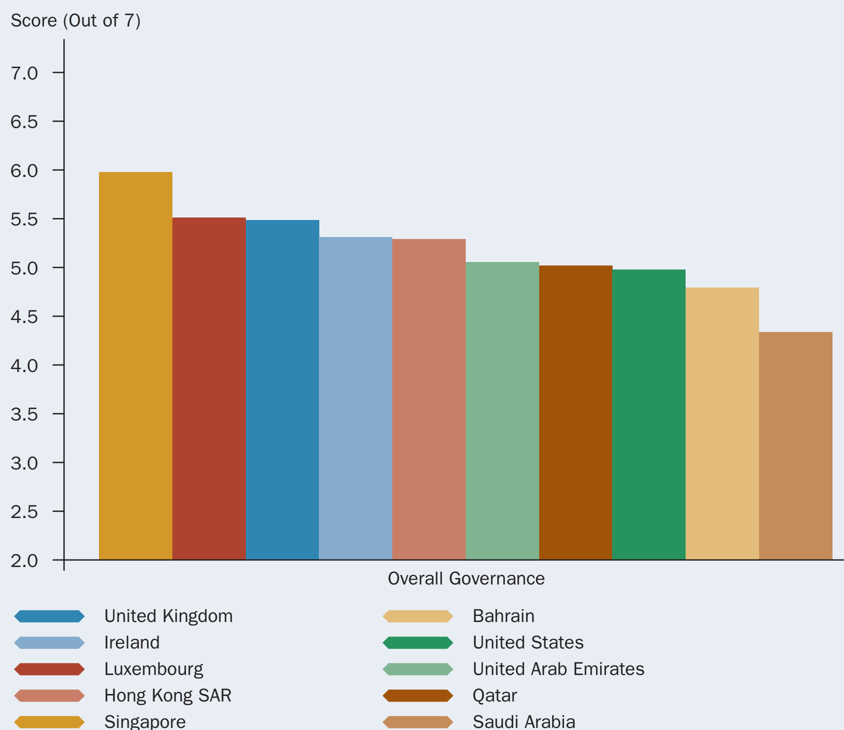
Here we examine soundness of banks, financial market sophistication and local equity market access (Chart 3). The UK leads on two of these factors (these rankings were generated before the Northern Rock crisis), followed by other Western markets, and Asia. The Gulf countries are weak in these measures. One might argue that the strength of the electronic infrastructure for tapping into the global market actually levels the field for these factors, but clearly the synergy in developed markets makes it an uphill battle for the new challengers.

TAXATION

Even without taking into account the current uncertainties of American and British tax policies, these two countries are ranked at the bottom (Chart 4). Existing rates and proposed substantial tax increases are encouraging decision-makers to consider alternative locations.

And, once started, it is hard to reverse this movement. For example, Japan previously reinterpreted "permanent establishment", dramatically increasing tax rates on hedge funds to 41 per cent. Not surprisingly, in subsequent years existing funds left and new ones popped up elsewhere. In 2006 only three hedge funds registered in Japan compared to 78 new funds in Singapore. Now Japan is trying to reform taxes to get these funds back. But once burnt is to be twice wary, and the funds are not eager to return despite many other advantages for locating in Japan.

CHART 5 – Governance



Source: World Economic Forum Global Competitiveness Report 2007-2008

In contrast, France's Minister of Finance sees opportunity in the UK's increased tax misery by stating that Paris's financial centre will be tax competitive for alternative investment management. Australia is trying to be more competitive in Asia by cutting withholding rates for foreign investors from 30 to 15 per cent from July 2008.

In this tax environment the Gulf countries have a chance to gain ground. Kuwait has reformed taxes. Qatar is also considering further reforms and ruling procedures to lower its rates relative to those in neighbouring jurisdictions. While traditional locations continue to abuse alternative investment management, the challengers are reacting and becoming more and more competitive and welcoming.

GOVERNANCE

This factor includes efficiency of company boards, ethical behaviour of firms, strength of auditing and reporting standards, presence of demanding regulatory standards, transparency of changes in policies and regulations, effectiveness of anti-trust policy, public trust of politicians and wastefulness of government spending (Chart 5).

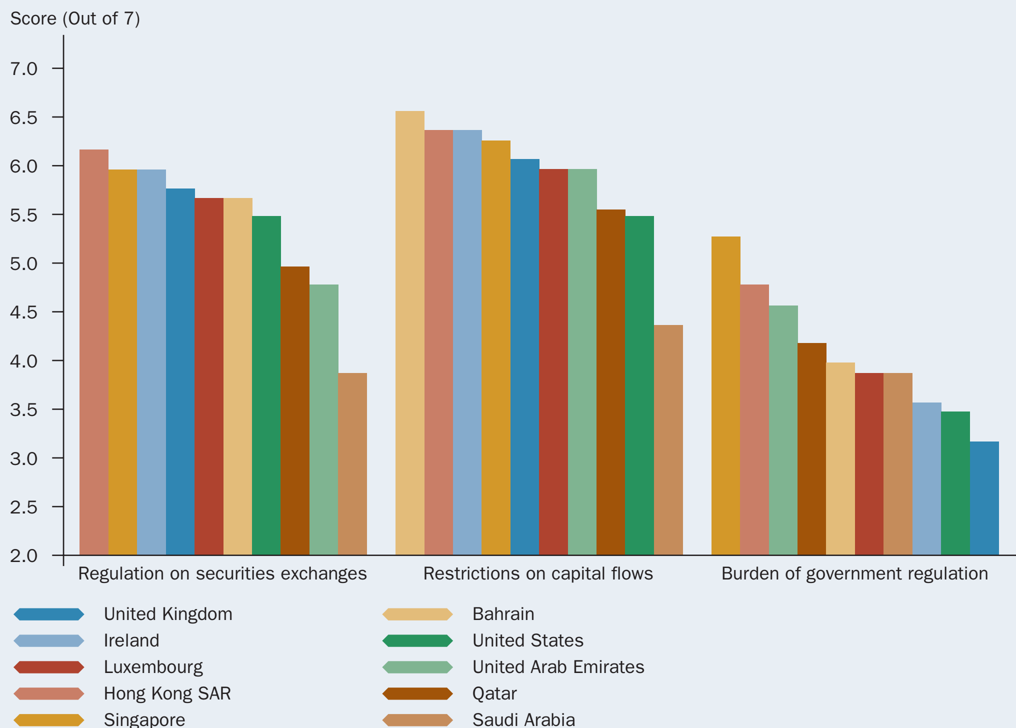
Superior governance does not take place in countries with the heaviest legislated burdens, the United States and United Kingdom, but in more appropriately legislated jurisdictions of Asia and Luxembourg.

The truth is that burdensome regulations can bite the back end of firms by diverting resources from strong internal controls. For example, in the recent Société Générale trading scandal the bank itself failed to avoid its near bankruptcy because the chief executive's and the company's time was wasted writing French Sarbox rules for a problem that happened in the United States. The time could have been better spent on drafting and enforcing internal rules. Surprisingly, the table shows that governance is comparatively more appropriate in Qatar than in the US.

REGULATORY ENVIRONMENT

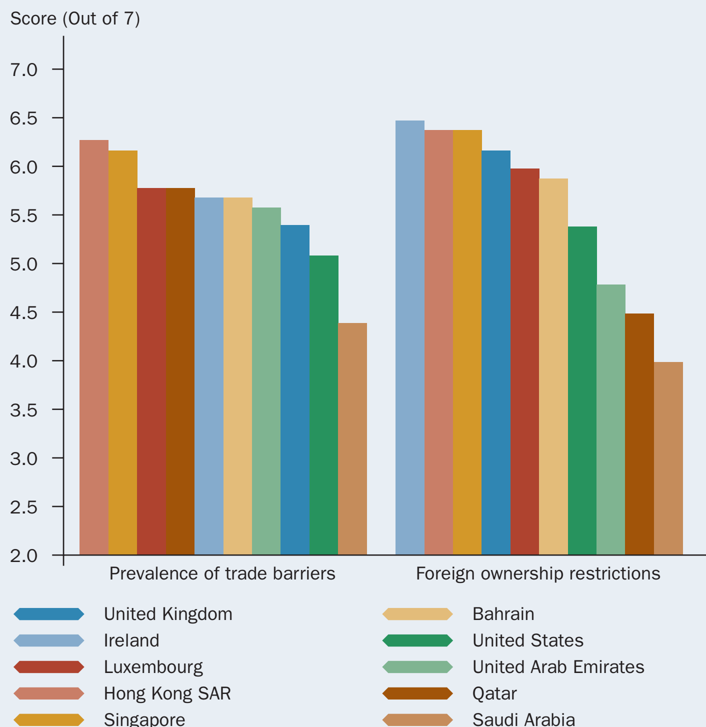
This factor focuses on specific securities exchange regulations, restriction of capital flows, the burden of government regulation, trade barriers and foreign ownership restrictions (Chart 6 and 7). In general, less onerous regulation exists in Asia and in some of the Gulf countries. Traditional locations are at the lower end of the scale.

CHART 6 – Regulatory Environment

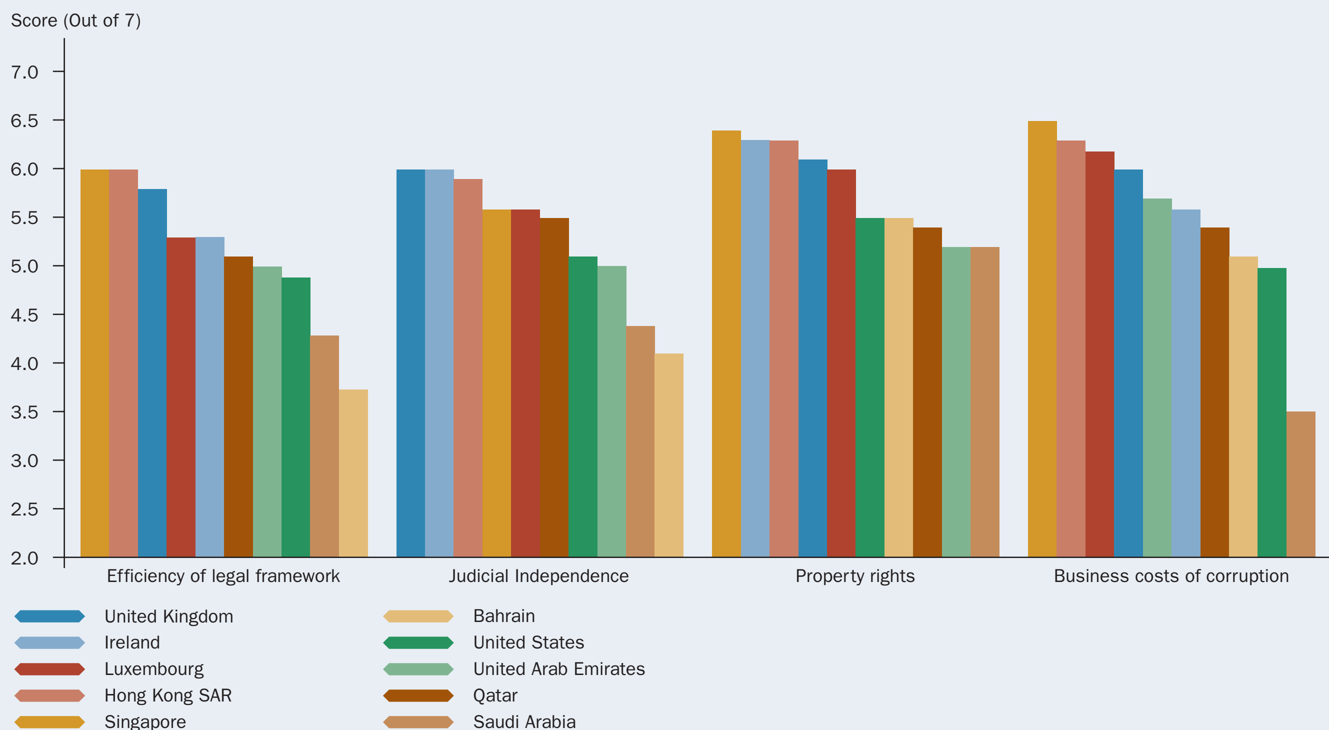


Source: World Economic Forum Global Competitiveness Report 2007-2008

CHART 7 – Regulatory Environment



Source: World Economic Forum Global Competitiveness Report 2007-2008



The art for any regulator is to achieve the right balance between regulation and freedom. The best locations have flexible yet effective and internationally recognised corporate governance.

Where there is too much regulation, innovation can be strangled and capital will flee to a more attractive location. Where there is too little control, the reputation of a financial or business centre will suffer, which means that companies and financial institutions will worry about placing their business there.

LEGAL ENVIRONMENT

The key elements are efficiency of legal framework, judicial independence, property rights and business cost of corruption. Here the United Kingdom and its former colony Hong Kong top the ratings. Such respect for the UK legal system is why Qatar chose to adopt the UK legal system for its QFC Civil and Commercial Court and Regulatory Tribunal to adjudicate civil and commercial legal issues.

Like Hong Kong, the judges on the Qatar court all have UK or Commonwealth experience. The Chief Justice is the former Lord Chief Justice of England and Wales, the Right Honorable Lord Woolf of Barnes. Another is Lord Cullen of Whitekirk, who as Lord Justice General and Lord President of the Court of Session was the most senior judge of Scotland.

By comparing key factors, the factors affecting any decision on which location to choose is clarified, opening it for discussion and further analysis. There are still many pitfalls. And to avoid them, key strategists must follow this disciplined thought process to assure the maximum competitiveness of their firms in a complex, dynamic and changing world of alternative investment management. Q

Note: In the next two issues of Quantum there will be comparisons of other factors including human resources, cross-cultural risks and infrastructure factors, followed by a presentation of cost and quality of living factors.