
Competitiveness Enhancement of International Financial Centres

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Abstract:

In recent years, international financial centres have become one of the most important elements of the international financial system. Increasing globalization of the world economy raises the role and influence of international financial centres (IFC) due to extending scope of activities of IFC that currently includes financial markets, international financial and lending relations, insurance, etc.

Financial centres make a substantial contribution to the overall economic development and growth of the country. The establishment and development of financial centres is a quite complex and complicated process that combines various historical, geographic, social, economic and political factors.

The establishment of international financial centres is related to financial liberalization processes as well as globalization of the financial market. According to the history of financial centres, a number of factors contribute to their establishment and development: geographic location, multicultural factors, liberal legislation, stimulating tax and customs policies, immigration legislation, competitive costs of financial services, etc. However, it is not always that financial centres are established in places with favourable economic, political and social factors. It requires both a combination and interaction of different factors, as well as political will and success.

The aim of the paper is basing on the examination of the factors influencing establishment of IFC, to analyze the directions of the competitiveness enhancement of Riga International Financial Centre by identifying its potential niche.

The following research methods have been used in the paper: generally accepted quantitative and qualitative methods of economic research, including comparative analysis and synthesis, graphic methods, expert methods, SWOT analysis.

Keywords: competitiveness, IFC, influencing factors.

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1. Introduction

The most important element of the international financial system of the latest years is international financial centres (hereinafter – IFC). Under increasing globalization of the world economy, the influence of IFC has been growing along with the steadily expanding range of IFC activities. Currently the activities comprise both the financial markets as well as servicing international finance and lending, insurance etc. Financial centres contribute significantly to the overall economic development and growth of the country. The establishment and evolution of financial centres is a rather complicated and challenging process that is based on the combination of various historic, geographical, social, economic and political factors. The international flow of capital depends on different factors, the decisive one is the force of attraction of the national financial system that involves the assessment of risk and investment profitability in financial markets, in other words, this force depends on the competitiveness of the economy (Popkova, 2016). Clients choose the services of a financial centre based on their confidence that their funds are in safe hands or it is just a transit stop in the flow of capital to a safer destination. In addition, there are other influential factors, such as staff, infrastructure and costs. However, the latter are of secondary importance.

Riga was first included in the Global Financial Centres Index (GFCI, 2017) in 2016 and ranked 52nd there. By 2017, it had strengthened its position in the GFCI to the 45th rank. This suggests the development potential of Riga as an international financial centre and now it is important to take well-considered actions by using various instruments, policies and procedures for raising its competitiveness. The aim of the paper is, based on the examination of the factors influencing establishment of IFC, to analyze the directions of the competitiveness enhancement of Riga International Financial Centre by identifying its potential niche. For achieving the aim the authors have identified the following tasks:

- To study the corresponding research literature;
- To assess the factors influencing the establishment of IFC;
- Based on the analysis of the industry experts' opinions, to assess the possible niche for Riga by conducting SWOT analysis.

The following research methods have been used in the paper: generally accepted quantitative and qualitative methods of economic research, including comparative analysis and synthesis, graphic methods, expert methods, SWOT analysis.

2. Research results and discussion

2.1 Factors influencing the establishment of an international financial centre

Before studying the factors that influence the development of an international financial centre it is important to determine the meaning of the term 'international

financial centre'. Firstly, a financial centre is a territory in a geographical sense of the word (a city, area, in some cases – a country). There are rather many definitions of a financial centre. For example, “a financial centre is a city (or a part of a city) (1) with a heavy concentration of financial institutions, (2) that offers a highly developed commercial and communications infrastructure, and (3) where a huge number of domestic and international trading transactions is conducted” (Businessdictionary). Nartins (2004) claims that a financial centre is a place that is characterized by a high concentration of banks and other financial institutions with favourable conditions for the development of a financial market. The city or region that serves as a coordination centre for a financial industry and where banks, stock exchanges and other financial institutions are concentrated. According to Zoromé (2007) a financial centre is a state or jurisdiction that offers financial services to non-resident high net worth individuals. Such financial centres are characterized by the diversity, availability and volume of financial services (Thalassinos and Liapis, 2014; Thalassinos *et al.*, 2015).

There is another opinion suggesting that IFCs are associated with the national financial market, and only in individual cases with the city where the offices of the big companies and basic infrastructure of financial market are located. This approach is supported by the International Economic Forum Index Xinhua and Dow Jones Development Index. According to this approach, IFCs are the centres where the investment supply and demand as well as financial intermediaries meet. The establishment of an IFC reminds of the model of gravitation when they attract capital from the countries where such centres are missing. As a result, the contrast increases because the IFC receives capital, instruments, investors and intermediaries while the other party loses them. Issuers, investors and intermediaries receive various preferences while working in an IFC, which, in turn, determines the outflow of capital from the countries with the national financial markets non-competitive with the IFC. In a long term, such a trend may result in the absence of developing financial markets in the world. There will only be developed markets that will take over all financial operations and transactions. Consequently, we believe that the transformation of the national financial market into a competitive financial centre should be the main issue on the agenda of Latvia as well.

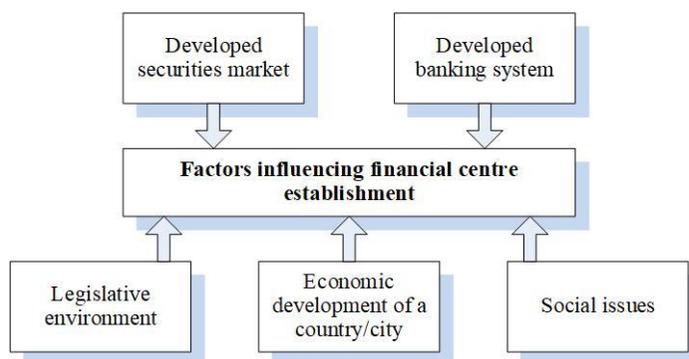
The development of international financial centres is related to financial liberalization processes (Yam, 2004) as well as globalization of international financial markets. As suggested by the history of financial centres, there several factors that determine and facilitate the development, such as:

- Geographical position;
- Multicultural factors (common history, traditions, religion, language, mentality, tolerance etc.);
- Openness of the economy to the movement of capital, labour resources and intangible assets;
- Liberal legislation, favorable tax and customs policy, immigration

- legislation;
- Simplified procedures for the registration of businesses and conducting transactions, low administration costs, low level of corruption;
- Introduction of international standards, their use, compliance in the area of accounts, regulation, reporting and surveillance;
- Infrastructure existence and development (stock exchanges, banks, insurance companies, investment funds, trust companies etc.);
- Competitive costs of financial services;
- Diversified range of financial instruments and services (shares, bonds, derivatives, indexes etc.);
- Macroeconomic and political stability in a country, a certain level of welfare etc.

However, based on the analysis of the research literature, we conclude that it is possible to identify five factors that provide for including a city/ country in the category of the financial centre (Figure 1).

Figure 1. Factors influencing the development of IFC



Source: Authors.

The prior factor is related to the existence and development of the securities market that involves, the existence of a trading system and diversity of the tradable instruments (capital, debt securities, futures, etc.) Over the recent years, a different approach has been developing regarding the above-mentioned criterion where the key role belongs the liberal financial legislation rather than to the volumes of trade and diversity of instruments, especially regarding transactions with non-residents. The above-mentioned development is confirmed by the fact that although NYSE turnover exceeded that of LSE by many times, according to GFCI 19 index (GFCI, 2016) in March, 2016, London ranked first among all financial centres. Regarding this factor, it is important to note that the IPO experience represents a very serious indicator influencing the competitiveness of the financial centre. IPO allows companies to raise the necessary funding to increase the equity capital under the condition that there is experience in organizing and implementing it and the

respective legislation. In 1990s the concept of global IPO appeared which means the primary issuing of securities outside the issuer's country. It is important to note that thanks to the harmonization of IPO legislation and standards with the international standards, several Asian financial centres have enlarged the scale and volumes of their operations (Yam, 2016; Thalassinos and Pociovalisteanu, 2014).

The second factor is related to the well-established and stable banking system, especially important is the presence of international banks. The presence of foreign commercial banks provides businesses and households with additional opportunities for raising funds; it improves the quality of products and services and increases profitability of the bank operation under severe competition. For example, 250 out of 500 banks in London are foreign banks, 80% of the Honkong banks are non-resident ones, in Switzerland approximately a half (Roth, 2002) of all banks are the subsidiaries or representative offices of foreign banks.

Certainly, the environment plays an important role in the establishment and development of an international financial centre. The legislative environment is characterized by the following: the legislative structure, governmental and non-governmental institutions that regulate the financial market, the level of regulation of the financial and capital market as well as the so-called level of financial freedom in financial markets (CCMR, 2006) and flexibility of the national policy to economic challenges. The aspects characterizing legislation are related to the following factors: protection mechanisms of investor rights, combatting money laundering etc. An important component is the degree of information openness that provides for the transparency of the financial system participants and allows for improved quality of the decisions adopted within the risk management procedure. Otherwise, there is a risk of the following chain of events: poor accounts→false information wrong decision low level of risk management financial crisis (Datuk and Andrew, 2006). Finally, a competitive level of taxes is the main component of the business climate. As the evolution history of Asian financial centres shows (Lee, 2001), the attractiveness of the taxation system is a more influential factor than the development stage of the banking system and stock market.

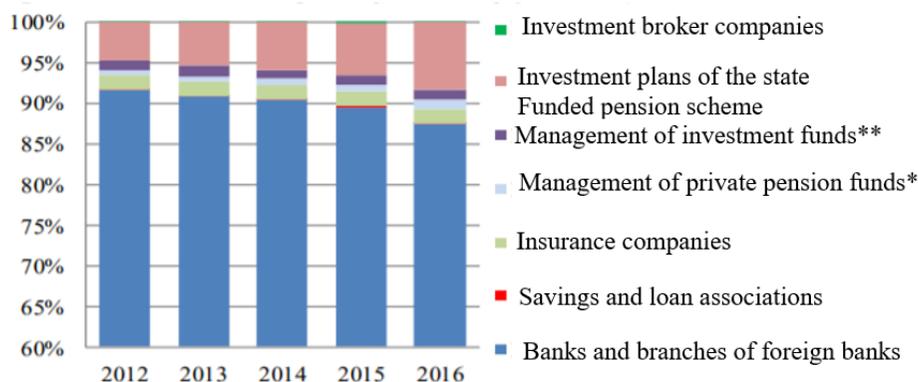
A very important influential factor is the level of economic development of the territory described by the term international financial centre. This factor comprises both the existence of professional institutions that offer a wide range of financial services as well as the availability of customers (Yeandle *et al.*, 2005), which essentially means that the offered services are demanded and the centre contributes to the national GDP.

The fifth influential factor is related to social issues: the development level of the business and transport infrastructure and availability of highly qualified staff. A certain living standard and quality implies the attractiveness of the financial centre for residential purposes and work (especially for non-residents) and it is assessed based on the following criteria: culture, health care, recreation and education level

(Yeandle *et al.*, 2005). Certainly of importance are such factors as the level of crime, terrorism etc.

However, not always financial centres develop in places with favourable economic, political and social factors. What matters is the combination or interaction of various factors as well as the political will and luck. Based on analysis of the research literature we conclude that the political will and government support in the establishment and development of IFC represents a very important component. This is suggested by the experience of Luxembourg that continues to foster its competitiveness internationally and has ambitious plans to become a global financial centre. This is also demonstrated by the recently adopted LUXFIN 2020 strategy. The national policy and support to the creation and competitiveness of the financial centre have also been decisive in the case of Singapore, Honkong and Ireland (Hong Kong Special Administrative Region Government, 2015; Arner and Gibson, 2015). At the end of 2016 the financial and capital market in Latvia had 313 financial participants with total assets of about 135% of the GDP of the country.

Figure 2. Market Participant Structure (by the proportion of total assets) in Latvia in 2012-2016.



Source: Authors' calculations based on FCMC data.

As shown in Figure 2, the share of the banking industry in the total assets of the financial sector gradually decreases as other participants of the financial and capital market evolve. However, the biggest share of the financial and capital market, i.e., 87.5% of the total assets is still constituted by the banking sector (~118% of the GDP at the end of 2016). The recent six-year decrease trend in the loan portfolio of the commercial banks of Latvia can be explained by the attempts of commercial banks to get rid of the accumulated credit risk that had resulted from the aggressive loan policies during the rapid period of economic growth in years between 2001 and 2008 (Solovjova and Rupeika-Apoga, 2016; Rupeika-Apoga and Solovjova, 2017). The banks operating in Latvia can be classified by their business models:

- Banks that service the local customer segment. This category of banks is dominated by the banks of Scandinavian origin: Swedbank AS, SEB bank, Nordea Bank AB Latvia branch, DnB are the biggest players in the segment offering financial services to local households and businesses;
- Banks that service the international customer segment. The international customer segment consists of several independent groups of banks – ABLV Bank AS, Rietumu Banka AS and Citadele banka AS are the three largest players in terms of deposits. The business of these banks is mainly targeted at the customers non-residents from the CIS countries (Japparova and Rupeika-Apoga, 2017).

In accordance with the study by KPMG (KPMG, 2015), the contribution of the banks in Latvia to the overall tax revenue and other related payments accounted for 188.7 mln EUR in 2014. That represents ca.2.66% of the total amount of taxes gained by the State Revenue Service of Latvia. The international customer segment of the banks in Latvia has contributed EUR 65.4 mln in taxes, which represents 0.92% of all taxes gained in 2014. In order to assess the significance and influence of the banking industry of Latvia especially that of the international segment, on the economy of Latvia, it is necessary to study its added value.

Figure 3. *The added value and direct effect on GDP of the international customer segment of the banks in Latvia from 2010 to 2014.*

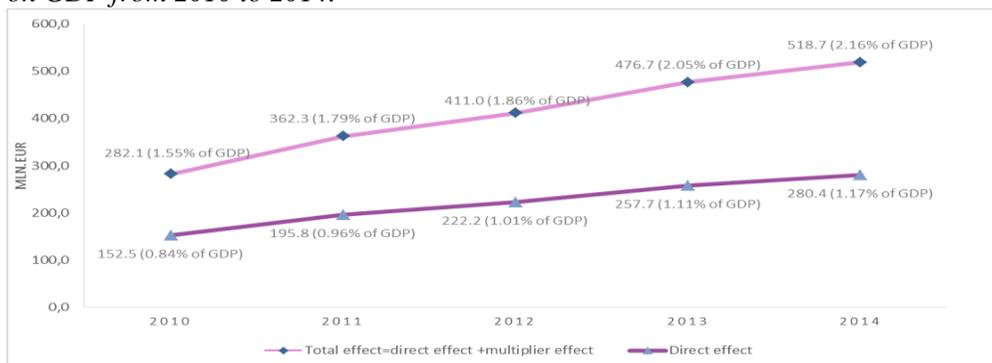


Source: KPMG data.

According to KPMG calculations (KPMG, 2015), the added value of the international bank customer segment and direct impact on GDP from year 2010 to 2014 increased by EUR 152.5 mln (0.84% of GDP) to EUR 280.4 mln (1.17% of GDP). This growth trend has been observed for five years.

Another indicator used to assess the performance of an industry is the multiplier effect.

Figure 4. Total effect of the international customer segment of the banks in Latvia on GDP from 2010 to 2014.



Source: KPMG data.

As suggested by the KPMG data, in 2014 the overall effect of the international customer segment of the banks in Latvia on GDP accounted for EUR 518.7 mln (2.16% of GDP), composed by the direct effect of EUR 280.4 mln (1.17% of GDP) and the multiplier effect of EUR 238.3 mln (0.99% of GDP). The data mentioned above show the significance of the international customer segment for the economy of Latvia and indicate the need for developing, improving and fostering the competitiveness of Riga as an international financial centre.

2.2 Directions for promoting the competitiveness of Riga as an international financial centre

In order to determine the directions of the competitiveness enhancement of Riga as an international financial centre, interviews with the industry experts (representing top management of Latvian commercial banks) were conducted. In total experts from 9 banks were interviewed in 2015-2016 with credit, deposits and capital market share more than 80%. One of the aims for interviewing the experts was to find out which niche Riga can take as a financial centre, i.e. to find out the possible specialization. Based on interviews we conclude that Riga can enhance its competitiveness as a financial center specializing on the following services:

- 1) transaction business (payment settlement). Currently all of the interviewed banks are engaged in the transaction business and they consider that this niche is one of the core elements of the banking business (Table 1).

Table 1. SWOT analysis of the transaction business niche

| Strengths | Weaknesses |
|--|--|
| <ul style="list-style-type: none"> ➤ commission fees from the payment services/payment cards as the largest source of income ➤ existence of relevant infrastructure, appropriate IT solutions ➤ qualified staff with knowledge of | <ul style="list-style-type: none"> ➤ risk of customer concentration due to high share of residents of CIS countries ➤ high reputational risks related to possible money laundering ➤ higher capital and liquidity |

| | |
|---|--|
| customers' language, mentality and culture ➤ stable customer base with high growth potential | requirements for banks that work in the international segment |
| Opportunities ➤ improvements in the AML/CFT area are needed (incl. investments in infrastructure and IT) to ensure inflow of "legal money" ➤ increase and diversification of the target market in order to increase income and create new jobs | Threats ➤ reduction of fees and commissions income (payment transactions, payment cards) ➤ growing investment in infrastructure needed to comply with the AML/CFT requirements ➤ worsen relations with the corresponding banks ➤ growing economic and geopolitical risks in the clients residence countries ➤ decrease of stable cash flows from the CIS countries due to the growing political and regulation risks ➤ sovereign credit rating downgrade of the country |

Source: authors' construction based on experts' opinions.

- 2) Financing of international trade, including financing of the trade turnover, stock financing, documentary operations. In one of the interviewed banks – AB.LV – this direction is considered a priority, and this is where they see their own possible niche as well as that of Riga as a financial centre (Table 2).

Table 2. SWOT analysis of the international trade financing niche

| | |
|--|---|
| Strengths ➤ Advantageous geographical location of Latvia that serves as a bridge between the West and the East ➤ well-developed general infrastructure, ports ➤ Presence of a port that is the closest to the East-European countries, therefore more convenient in terms of logistics ➤ The depth of the port enables hosting deep draft vessels ➤ well-developed financial service provider infrastructure (banks, products, multilingual staff) ➤ Larger value added of the services | Weaknesses ➤ unpredictability of the tax policy ➤ lack of preferences and reliefs regarding taxation ➤ lack of government support |
|--|---|

| | |
|---|---|
| <p>compared to the transaction business, increasing income of the banks and contributing to GDP growth</p> | |
| <p>Opportunities</p> | <p>Threats</p> |
| <ul style="list-style-type: none"> ➤ increase of state budget income and creation of new jobs in the banking sector and real economy ➤ reinforcement of Riga as a big European port and an important North European transit hub and financial centre ➤ the localization of trade companies in Latvia (to found the representative trade offices in Latvia, for example, the Joint Stock Company “United Chemical Company URALCHEM”), then it would be easier for banks to serve them by offering various options for financing trade ➤ development of a logistics centre, respective infrastructure (warehouses, construction of terminals) to increase the flow of goods through Latvia (the speciality of Latvian trade – non-exchange-traded commodities) ➤ need for a customer-oriented tax administration ➤ it is necessary to create a structural unit of the State Revenue Service that would service foreign tax payers (providing for the possibility to complete reports in English and work in accordance with SGS, more flexible policy in writing off expenses etc.) | <ul style="list-style-type: none"> ➤ geopolitical situation (conflicts), high political risks, trade barriers, embargo ➤ currency risk as transactions are mainly in USD ➤ increasing regulatory risks and unclear rules for the business ➤ lack of trust in the banking sector |

Source: Authors’ construction based on experts’ opinions.

- 3) Private banking, including management of private assets. The philosophy of private banking is aimed at maintenance and reinforcement of accumulated wealth, provision of financial stability to clients from generation to generation with a maximally personalized orientation at the client, based on the individual needs and aspirations (Table 3).

Table 3. SWOT analysis of the private banking niche.

| Strengths | Weaknesses |
|--|---|
| <ul style="list-style-type: none"> ➤ qualified staff with knowledge of the customers' language, mentality and culture ➤ stable customer base with high growth potential | <ul style="list-style-type: none"> ➤ lack of highly qualified private bankers ➤ high risk of customer/wealth concentration due to clients' structure in terms of residence ➤ insufficient positive positioning of the banking sector on the national level that might exert a negative influence on individual banks and the banking system as a whole. |
| Opportunities | Threats |
| <ul style="list-style-type: none"> ➤ wealth management strategy development (Deloitte, 2015) ➤ increasing number of high-net-worth individuals globally (McKinsey&Company Research Report, 2014) ➤ attracting customers from other regions (e.g., Singapore initially focused on servicing Chinese customers, but now is an international financial centre) ➤ minimization of reputational risks will increase the contribution of the service to the economy as a whole | <ul style="list-style-type: none"> ➤ severe competition (Switzerland, Luxembourg etc.) ➤ low profitability of financial instruments that might lower the income from capital management and increase the appetite of the bank risk ➤ amendments in legislation asking for deeper examination of customers and provision of information to other institutions might create difficulties in provision of services and cause customer dissatisfaction |

Source: Authors' construction based on experts' opinions.

3. Conclusions, proposals, recommendations

1. As it is suggested by the analysis of the factors influencing the establishment of international financial centres, the development and competitiveness of IFC depend on a number of factors: development of the banking system, development of the securities market; secure banking system; legislation environment etc. Besides, the development of IFC needs government support and well-balanced national policy aimed at enhancement of the IFC competitiveness.
2. The role of the banking industry in the redistribution of the financial resources cannot be overestimated. The banking industry is one of the basic components of economy that ensures movement of capital into various sectors of economy and, consequently, the funding of the real sector and households takes place. As the commercial banks of Latvia servicing the international client segment, contribute significantly, both directly and in multiplier terms, to the GDP of the country, a support programme is necessary to ensure meeting the international standards and requirements.

3. Riga can enhance its competitiveness as a financial center specializing on particular services. Analysis of the interviews with leading industry experts shows that the following directions of specialization could be developed: transaction business, financing of international trade and private banking.

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