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Adaptation strategies of Luxembourg's financial centre under pressure

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Abstract

The financial crisis has highlighted the vulnerability of International Financial Centres (IFCs). However, very little is known about specialised IFCs, in particular about the impact on their niche activities and the strategies they have developed to return to growth. This article addresses these questions by examining the case of Luxembourg. Firstly, the findings suggest that the increasing concentration of financial services companies has over time created agglomeration economies and contributed to making Luxembourg one of the few global specialist financial centres. IFCs such as Luxembourg are part of a new environment in which competitive advantage will increasingly be based less on regulatory issues and more on the diversity and quality of the services offered. Secondly, the evolution of the financial industry in Luxembourg suggests that a strategy of continuous innovation has been adopted to maintain the comparative competitiveness of the financial centre.

Niche markets within the global financial system

The ongoing financial crisis has highlighted the vulnerability of International Financial Centres (IFCs) and the importance of adaptation strategies to the geography of finance. London and New York, for example, have reported large losses of assets and jobs since the beginning of the crisis in June 2007 and the bankruptcy of Lehman Brothers in September 2008. However, little attention has been paid to the impact of the crisis on the category of smaller IFCs, also known as "sub-centres" (Grote, 2009) or "global specialists" (City of London, 2010), which have become important international hubs for wealth management, commodity trade finance, insurance and reinsurance, or investment funds, such as Geneva, Dublin and Luxembourg (Roberts, 1994). In the context of increasing pressure from national regulators and international bodies, what has been the impact of the crisis on their niche activities? What strategies have they developed to recover from the crisis and return to growth? These issues are addressed by examining the case of Luxembourg and questioning the two major clichés commonly applied to its financial centre.

In accordance with the first cliché, it is often assumed that Luxembourg is too dependent on the domestic markets of its neighbours to develop as an autonomous financial market. Our hypothesis is, however, that far from being limited to being a "tax paradise", which is what the first part of our title – quoting a disenchanted German banker – refers to, the development of the sector is now in addition increasingly dependent on agglomeration economies. As the financial activity and diversity of the establishments in question increase, we assume that the advantages of the niche policy cannot by themselves explain the sustainability of Luxembourg. We believe that specialised IFCs such as Luxembourg are part of a new environment, in which differentiation will increasingly depend less on regulatory issues and more on the diversity and quality of localised services.

The second common cliché is that Luxembourg is a fragile IFC due to the typical advantages of a niche policy, notably banking secrecy and tax incentives (Palan, Murphy and Chavagneux, 2010). These advantages could be threatened by the mobility of capital at the global level and by developments in terms of regulation at the EU level. However, unlike those who consider that such countries have "failed to move with the times" (Palan, 2003, page 112), our hypothesis is that Luxembourg had to constantly innovate in such a way that the deregulation, which has taken place from the 1980s onwards, did not erode its comparative advantages. Until now, this strategy has appeared to be successful, as exemplified by the adaptive efforts made in the fields of investment funds, private banking and financial engineering over the past twenty years or so, as well as more recently in the areas of estate management, securitisation, venture capital and reinsurance (OECD, 2008). To avoid any misunderstanding, it should be stated that even when focussing on certain success factors and current challenges for this comparably young and fast-growing financial centre, we will neither be advocating a "Luxembourg model" – see Clark and Wójcik's (2005) criticism of generalising case studies – nor do we intend to base our argument exclusively on a regional innovation system approach. We are, rather, interested in the way a specific local environment with its corporate and public actors and the resultant institutional setting is intertwined with overarching international development trends and regulatory constraints.

The first part of the paper reviews the literature concerning specialised financial centres, focusing on the geography of finance and offshore issues. The second part presents the methodology and data. In the third part, we discuss the contribution of the financial centre to the national and regional economy and examine how Luxembourg has dealt with the crisis from 2007 onwards. More specifically, the paper examines the extent to which Luxembourg

has developed endogenous competitive advantages going beyond regulatory incentives. The fifth part illustrates the strategy of innovation followed by Luxembourg and the remediation strategies developed to ensure the sustainability of the IFC. The final part concludes by stressing Luxembourg's potential to adapt to the present turbulent times and considers some of the long-term perspectives.

Scholarly debates on specialised financial centres

Over the past decade, numerous attempts have been made to classify financial centres in a hierarchical way, considering either quantitative indicators related to the presence of company headquarters (Choi, Park and Tschoegl, 2003) or the relative size of financial markets (Poon, Eldredge and Yeung, 2004), or a mix of quantitative indicators and assessments from the industry itself (City of London, 2010). While the ranking of financial centres may vary according to which indicators are used, geographers tend to divide them into three major groups: (1) world financial centres such as London, New York and Tokyo, which are unchallenged in their respective areas; (2) second-tier financial centres such as Paris, Frankfurt, Amsterdam or Milan, which clearly dominate the national and sometimes the regional area; and (3) sub-centres such as Munich, Geneva, Dublin or Luxembourg, which have developed special competencies (Grote, 2009). The first two categories seem to have attracted most of the scholarly interest, especially London (Thrift 1994; Taylor et al, 2003; Roberts, 2008), New York (Schwartz, 1992; Longcore and Rees, 1996; Pohl 2004), and Frankfurt (Grote, Lo and Harrschar-Ehrnborg, 2002; Grote, 2008; Faulconbridge, 2004; König et al, 2007; Schamp, 2009).

However, work examining the importance and sustainability of sub-centres within the global economy has been rather limited (see Murphy 1998; Sokol 2007). Luxembourg is no

exception to this. Some comparative studies conducted at the European level still ignore the city despite its key role within the geography of European finance (Tschoegl, 2000; Karreman, 2009), while other worldwide studies do not comment on the specificities of the location (Poon, 2003; Poon, Eldredge and Yeung, 2004), or consider such international financial centres only as offshore centres (see Cassis 2006). As a result, most of the studies on the development of the financial industry in Luxembourg have been produced by consultancies or by a small number of academics (Hübsch 2004; Franz, 2005; Bourgain and Pieretti, 2006; Pieretti, Bourgain and Courtin, 2007; Walther and Schulz 2009).

Interestingly, the literature on sub-centres seems to be divided into two bodies of literature, which do not often overlap, as was already noted by Murphy (1998) over ten years ago. One of the main challenges when studying sub-centres is, therefore, to combine the geography of finance approach, which deals primarily with the centrifugal and centripetal forces explaining the concentration of financial activities, and the approach developed by scholars of international relations and political economy, dealing with the legal and regulatory incentives of offshore financial centres and state sovereignty. As noted by Hudson (2000), some convergence between the two approaches has been seen recently. This is all the more necessary given that far from being isolated and purely opportunistic, the rise of the so-called offshore centres is structurally linked to the changing world economy (Hudson, 1998), and in particular the internationalisation of capital (Palan, 2003).

As with any other financial centres, three major types of factors influence the development of sub-centres: the nature of financial products, classical Marshallian externalities, and social networks (Gordon and McCann, 2000). Firstly, as showed by Clark and O'Connor (1997, page 95), "financial products often have a distinct spatial configuration of information

embedded in their design". Small financial centres are more likely to specialise in opaque products which require a greater degree of non-codified knowledge, such as private equity, mergers and acquisitions transactions, and in translucent products such as hedge funds, rather than in transparent products such as currency exchange, which tend to be concentrated in a limited number of large IFCs, in order to benefit from economies of scale. Given that opaque products have a tendency to be transformed into more transparent products, IFCs can maintain their competitive advantages in two ways: by developing their intermediation capacity as gatekeepers mediating between outsiders from global markets and local knowledge, and by transforming transparent products into translucent products by attracting skilled traders (Faulconbridge et al, 2007).

Secondly, there is no doubt that labour market pooling, the supply of intermediate goods and technological and informational spillovers play a fundamental role in the formation of financial sub-centres (Porteous, 1999; Gehrig, 2000; Storper and Venables, 2004). Even though agglomeration economies favour those markets where the density of employment and of companies is at its highest, the growth of smaller-sized financial centres can also follow from extreme specialisation, encouraged by the exploitation of a niche related to national sovereignty. Certain initial comparative advantages can then result in a cumulative process in which the location of banks that are attracted by framework conditions can subsequently increase the attractiveness of the location for banks that are not yet established there (Grote, 2008).

Thirdly, small international financial centres also connect individuals who share social and cultural values and interact within social networks (Thrift, 1994). The exchange of these values is essential to maintaining trust and reputation, the two pillars upon which much of

financial intermediation relies. Social relationships, informal rules and interpersonal networks established in business are thus constitutive of markets (Peck, 2005). The effectiveness of these standards and rules is greatly enhanced by the physical proximity between actors, which is usually found in financial districts and small-sized IFCs (Longcore and Rees, 1996; McDowell, 1997).

The second body of literature relevant to the case of specialised IFCs deals with the rise of offshore finance and the reworking of state sovereignty (Roberts, 1994; Hudson, 1998; 2000; Vlcek, 2008). A major contribution of this literature has been to analyse the diversity of financial centres and to distinguish between international financial centres, offshore centres and pure tax havens (Palan, Murphy and Chavagneux, 2010). An offshore financial centre is usually considered as a country or jurisdiction that makes its living "mainly by attracting overseas financial capital" and offers "foreign businesses and well-heeded individuals (…) low or no taxes, political stability, business friendly regulation and laws, and above all discretion" (The Economist, 2007, page 3), whereas tax havens are regarded as "countries that have enacted tax legislation especially designed to attract the formation of branches and subsidiaries of parent companies based in heavily-taxed industrial nations" (Starchild, 1994, page 1).

The heterogeneity of financial centres has long presented a problem to such classification (IMF, 2000), as is well illustrated by the case of Luxembourg. On the one hand, Luxembourg has been regularly identified as an offshore financial centre (Palan, 2003; Zoromé, 2007), due to its favourable income tax rates and banking secrecy rules. On the other hand, the country is a robust, efficient and well-supervised financial centre with sound institutions and has developed one of the most stringent regulatory regimes with regard to money laundering,

which has nothing in common with badly-run tax havens in the Caribbean Sea or the Pacific (IMF, 2002). As Schaus (CSSF, 2004, page 5), former Director General of Luxembourg's Financial Sector Supervisory Authority (CSSF) argues, Luxembourg cannot be easily reduced to one or the other category: "Luxembourg has never been an offshore financial centre, as it has never developed in the absence of tax or regulatory constraints. It will never be an onshore financial centre like any others either, as it will always be dependent on foreign capital".

Another contribution of this approach has been to show that offshore finance does not act on the margins of the international financial system but rather is closely interrelated with it (Palan, Murphy and Chavagneux, 2010). Although the statistical data remain unclear, a great deal of evidence suggests that offshore finance processes or manages a huge proportion of the money coming from or going into the world economy, estimated at 51% of all cross-border assets and liabilities – about $ 5 to 7 trillion in 2007 (The Economist, 2007). Accordingly, offshore financial centres are now not limited solely to tax avoidance but rather are deeply integrated into the globalised economy. A third contribution of that approach has been to make clear that offshore finance did not appear from nowhere but rather was encouraged by certain Western countries, at least until the late 1990s when a campaign against "harmful tax competition" (OECD, 1998) and pressure from the EU on international policy regarding offshore activities developed (Hampton and Christensen, 1999).

Methodology and data

Our analysis of the impact of the crisis on the financial industry in Luxembourg is developed using primary and secondary data from various sources, before and after the financial crisis. Drawing inspiration from the study carried out by Taylor et al. (2003) on the City of London, a questionnaire seeking to identify the main advantages of a Luxembourg business location was sent at the beginning in June 2007 to 424 firms in the financial sector. Of these, 128 were banks, 110 were insurance and reinsurance companies, and 185 were Professionals of the Financial Sector (PSFs), i.e. enterprises either connected with or complementary to the financial sector. The final sample consisted of the 44 banks, 22 insurance and reinsurance companies and 43 PFSs which answered our questionnaire. The study was complemented by 22 personal semi-directed interviews with top managers from a sample of those 100 global service firms identified by Taylor (2004), of which 48 were located in Luxembourg at that time. Interviews were conducted with high-ranking representatives of banking and financial firms, as well as insurance, accountancy, law and management consultancy firms. This survey provides information on the financial industry just before the financial crisis.

As far as the post-crisis period is concerned, interviews were conducted in 2010 with a selection of 10 bankers, fund managers, representatives of the professional bodies and the CSSF. The main objective was to assess the impact of the crisis and the remediation strategies developed by the local actors. Secondary data were also collected, including statistics from the National Statistical Office, the Central Bank of Luxembourg, the European Fund and Asset Management Association, and the CSSF. Consultancy reports, policy documents from the UE and the OECD, press statements and the relevant scientific literature have also been examined. These secondary sources provide further quantitative details on the impact of the financial crisis from 2007 to 2010.

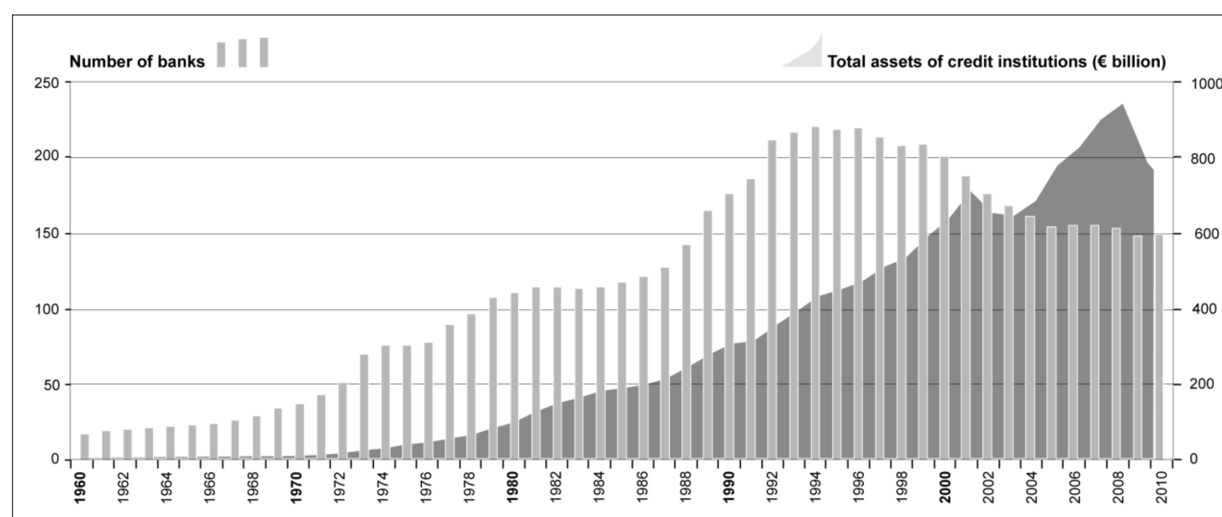
Luxembourg as a global specialist

Because of the quality and depth of its financial services, Luxembourg has been described as a “global specialist” (City of London, 2010). It is considered to be the leading private banking centre in the Eurozone, the second-largest mutual fund centre in the world, and the leading captive reinsurance market within the EU (LFF, 2009). This section examines the origins of its niche policy and the consequences of the financial downturn, and presents some of the factors that allowed Luxembourg to be resilient through these turbulent times.

The rise of the international financial centre

Three main periods can be distinguished with regard to the development of Luxembourg as an IFC. A first period, starting in the 1960s, during which Luxembourg became home to American and European banks working in the Euromarket (OECD, 2008); a second period, starting in the early 1980s, during which private banking and investment funds became increasingly important; and a third period, starting in the 2000s, in which more sophisticated and less regulated funds were introduced, as well as insurance and reinsurance activities. Throughout the period from the 1960s to the mid-2000s, the success of the Luxembourg financial market was characterised by sustained growth in the balance sheets of banks. While the economic crisis in 2002 and 2003 saw a temporary fallback, growth began again from 2004, with a maximum of € 1,002 billion reached in October 2008 (Figure 1). The number of banks reached a peak in 1994 (222), before undergoing constant decline due to M&A activity that characterised the sector at the international level.

Figure 1. Number of banks and their balance sheets, 1960-2010



Sources: CBL, CSSF. Illustration: the authors.

One of the characteristics of Luxembourg as a financial centre is its domination by foreign banks. As shown in Table 2, branches and subsidiaries from Germany constituted a third of the total number in Luxembourg in 2009, followed by banks from France, Italy, and Switzerland.

Table 1. Origins of the banks, 2001 and 2009

Country	**2001**		**2009**	
	Number	Proportion	Number	Proportion
Germany	59	31.2	45	30.2
France	17	9.0	15	10.1
Italy	21	11.1	11	7.4
Switzerland	12	6.3	11	7.4
Belgium and Luxembourg	20	10.6	14	9.4
UK	6	3.2	8	5.4
Sweden	6	3.2	7	4.7
USA	6	3.2	6	4.0
Japan	5	2.6	5	3.4
China	4	2.1	4	2.7
The Netherlands	5	2.6	4	2.7
Israel	5	2.6	3	2.0
Others	23	12.2	16	10.7
Total	***189***	***100.0***	***149***	***100.0***

Source: CSSF

Subsidiaries whose headquarters are located in Frankfurt, Paris and Brussels are particularly numerous (Walther and Schulz, 2009), illustrating the key role played by Luxembourg for neighbouring European economies. Today, despite the fact that about 70% of them are subsidiaries of well-known banks, the number of banks employing less than 50 employees has decreased sharply over the last decade, from 63% in 2000 to 52% in 2009 (CSSF, 2010). This shows that, unlike in some offshore financial centres, banks in Luxembourg are far from being empty shells with merely a minimal physical presence in the country (the average of workers per bank was 177 in 2009).

Today, the financial sector is by a considerable margin the main driver of the national economy. With 55,000 jobs directly linked to the financial services, the sector accounts for 22% of domestic employment, 31% of public revenue and 38% of Gross Domestic Product (Deloitte, 2009). Table 2 shows that the sector experienced strong annual average growth (4.7%) between 2000 and 2009, particularly for PSFs (+18.4%) and Undertakings for Collective Investment firms (UCIs) (+89.4% from 2003), which benefit from the outsourcing of certain activities previously carried out by the banks.

Table 2. Employment in the financial sector, 2000-2009

	2000	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**
Banks, Stock Exchange, Cetrel	23,321	23,952	23,600	22,839	22,869	23,550	25,084	26,457	27,524	26,740
Insurance and reinsurance companies	9,268	9,532	9,556	9,579	9,555	9,662	9,769	10,886	11,087	11,877
PSFs	3,499	4,176	4,399	4,455	6,059	6,547	9,928	12,174	13,507	13,485
UCIs companies	0	0	0	98	507	1,572	2,069	2,348	2,386	2,308
Total	36,088	37,660	37,555	36,971	38,990	41,331	46,850	51,865	54,504	54,410

Sources: CSSF, CAA, Cetrel and IGSS.

Even without taking the PSFs into account, Luxembourg had more employment directly linked to finance and more banks than Geneva (Geneva Financial Center, 2009), and more than Dublin's international financial services centre, which was home to 24,906 jobs at the end of 2008 (Finance Dublin, 2009).

The impact of the crisis: not as severe as expected?

The recent financial crisis certainly hit Luxembourg (OECD, 2010), but the financial sector seems to have recovered fairly rapidly. In terms of employment, job losses represented only 2.3% of the workforce in the financial sector as a whole and 2.9% in the banking industry in 2009. PSFs have lost only 1.0% of their workforce, while employment in UCIs remained stable over the period (CSSF, 2010). These figures indicate that job losses in Luxembourg were, proportionally, similar to those in Geneva (2.6% in banking from September 2007 to July 2009, according to the Geneva Statistical Office), and less significant than in world centres such as New York, which is reported to have lost 8.8% of its jobs in banking and financial services between 2007 and 2009 (Bloomberg, 2009), or London, where net job losses in financial services are estimated at 15.3% of the employed workers over the same period (City of London, 2010). Even Dublin, which performed well in 2008, is expected to have lost jobs in 2009 and 2010 (IBEC, 2010).

In terms of assets, the balance sheets of banks shrank from 951 to 793 billion (-16%) between 2008 and 2010, but only a limited number of subsidiaries from Iceland closed, while mergers and takeovers of larger groups had certain impacts on Luxembourg (e.g. the takeover of Sal. Oppenheim by Deutsche Bank in 2009). Despite being more limited than in many other OECD countries (OECD, 2010), the state interventions have proved successful. A substantive loan of € 2.5 billion (6% of the country's GDP) was converted into equity in December 2008

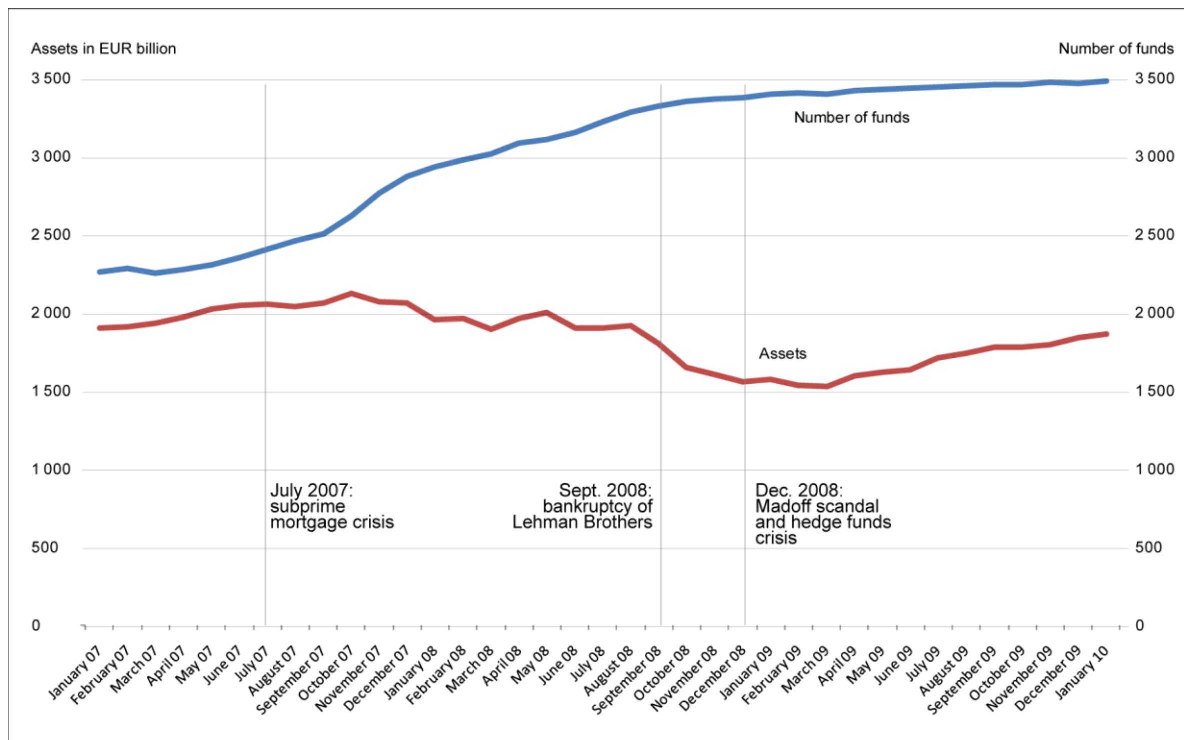
in order to re-capitalise part of Fortis's banking activities in the country, reutilising its former name Banque Générale du Luxembourg (BGL) in a joint enterprise with BNP Paribas, which holds the other two third of BGL's capital. Luxembourg also acted together with Belgium and France to support Dexia. A total of € 400 million of public subsidies was spent to rescue Dexia Banque Internationale à Luxembourg, whose group was the second largest employer in the country after ArcelorMittal.

Banks saw a positive change in their net profits, which increased from € 218 to 2,740 million between 2008 and 2009, compared to € 4,739 in 2007 (-42.2%) (CSSF, 2010). In a context in which private banking assets declined by 15% and operating profits margins dropped by 27% in Western Europe in 2008 (McKinsey, 2009), the Luxembourg private banking sector has done surprisingly well during the crisis. It is true that net inflows have been stagnating since the beginning of the crisis, reaching 2% in 2007 and 0% in 2008; however, private banks located in Luxembourg remain among the most profitable in Europe, thanks to a profit margin that has been higher than that of the banking industry in general (Deloitte, 2009). The insurance and reinsurance sector has fared well over this difficult period, with an increase in net profits of +98% in 2009 in comparison with the previous year, especially for life insurance. These good performances result from a strategy favouring non-risky vehicles, from better protection against debtors than that enjoyed by banks, and from the arrival of the Swiss reinsurer SwissRe, which inaugurated its European headquarters in Luxembourg in 2009 to benefit from the EU's Reinsurance Directive which allows companies to do business in any other EU member state once a reinsurer is allowed in one member state (EC, 2005).

The fund industry also appears to have weathered the crisis well. Luxembourg experienced one of the strongest asset growths in 2009 (+19.1%), and accounts for a third of all assets in

the Undertakings for Collective Investment in Transferable Securities (UCITS) market in Europe (Efama, 2010). The country is the world's leading location for cross-border distributed UCITS and seems to have retained the confidence of investors, even though funds from Luxembourg used by US or UK funds as intermediate vehicles for investing in Germany or France have dropped because of the crisis. As shown in Figure 2, the total assets under management in January 2010 are approximately the same as before the crisis in January 2007 (€ 2.1 trillion), while the number of funds increased steadily over the period, reaching 3,500. The industry was not affected by the Lehman Brothers bankruptcy and "only" € 1.9 billion were lost in the Madoff scandal in 2008. Since the beginning of the crisis, only about 10 funds have been suspended.

Figure 2. Number of funds and assets under management, 2007-2010



Source: CSSF.

Tax incentives and spillover effects

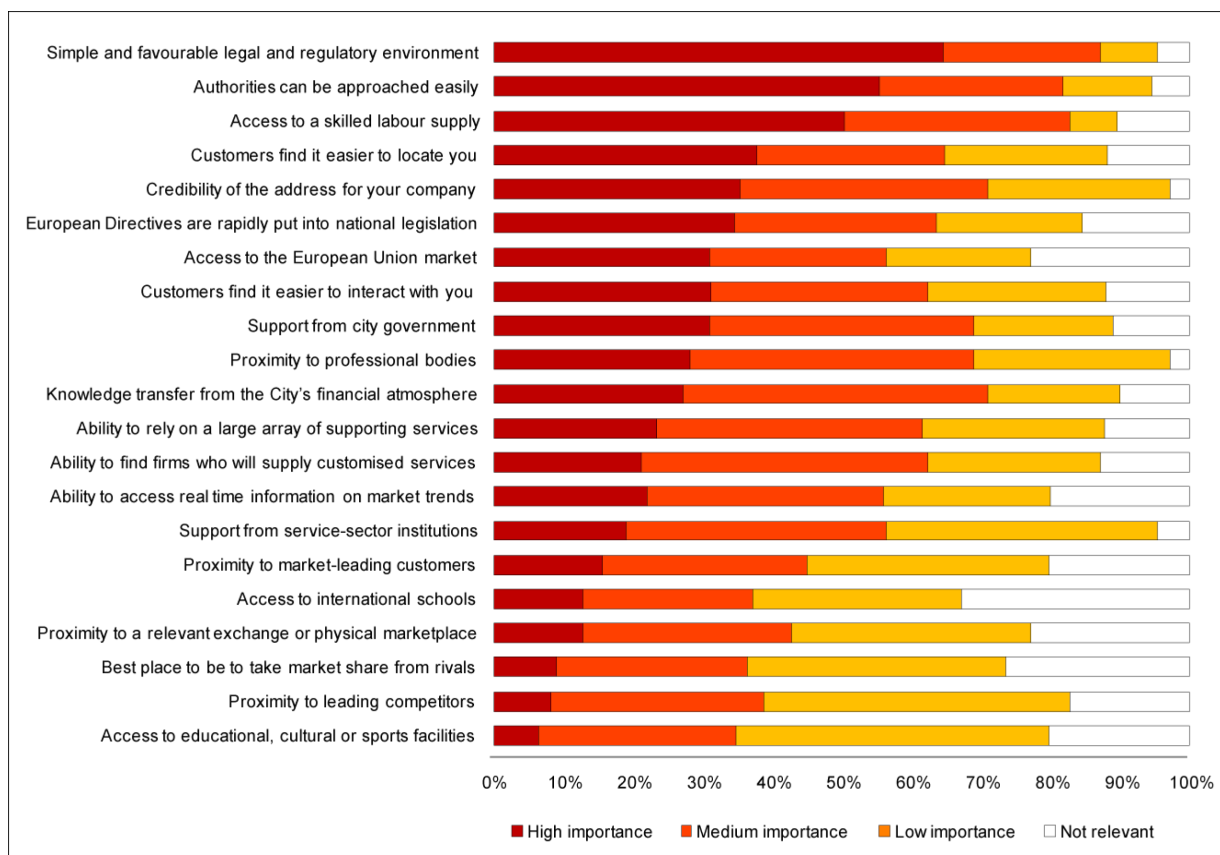
One of the reasons why Luxembourg performed well during the crisis is related to the fact that tax incentives are also complemented by spillover effects. Even though the origins of Luxembourg's financial centre are due in large part to an ongoing and highly-adaptable niche policy, the role of the latter is increasingly added to by other locational advantages. These include both endogenous agglomeration advantages, as well as Luxembourg's strong ties to international networks.

As Figure 3 indicates, the most widely cited reason for doing business in Luxembourg City remains the "simple and favourable legal and regulatory environment". This aspect is strengthened by the importance granted to the adaptability of its legislative and regulatory framework. Luxembourg has a first mover advantage in that European directives are rapidly transposed into national law. This allowed Luxembourg to become the first country of the European Union to apply the regulation on UCITS I, encouraging the domiciliation of investment funds as early as 1988. Other regulatory modifications in the field of international pension funds and new financial engineering products intended to replace holding companies dating back to 1929 have since then strengthened the sector. Luxembourg has recently introduced two new instruments: the Risk Capital Investment Company (SICAR), an investment fund created in 2004 and which does not impose any restrictions on portfolio investments or investment policy, and the Specialised Investment Funds (SIF), created in 2007 to anticipate the forthcoming EU Directive on Alternative Investment Fund Managers (AIFM) (OECD, 2010).

In addition to these regulatory factors, Figure 3 also confirms that the time of the exclusive tax niche has gone, meaning that endogenous forces are increasingly important. The financial

centre having reached a certain size, the installation of a great number of foreign banks attracts those banks that are not yet installed there, for reasons of either competition or credibility. This effect contributes to the critical mass effect of the financial market where this movement also goes along with a strengthening of the financial sector in the strict sense, in the area of insurance companies and advanced services enterprises, and in the fields of audit, accounting, law or information technologies.

Figure 3. General advantages of a Luxembourg City location, 2007



Note: N= 109 firms. Source: the authors.

As far as endogenous forces are concerned, the interviewees appreciated the proximity to local and national authorities and to professional bodies. As a manager of a large Swiss bank asserts: "Here in Luxembourg, it's probably an advantage to have a close relationship to the

regulators. You can really ask them for advice. In Germany or in Switzerland, it's not that easy or it's nearly impossible to call the BaFin [the German Federal Financial Supervisory Authority] and say 'Hey, I have a new business idea and how is your attitude towards this?'" (interview, 21st June 2007). Local contacts are made easy by the small size of Luxembourg City – 90,000 inhabitants but 150,000 jobs – and by the extremely high concentration of financial services within the CBD and the Kirchberg area.

These factors promote face-to-face contacts. It is true, as Boschma (2005) argues, that spatial proximity is neither a necessary nor a sufficient condition for localised knowledge spillovers to develop. In an urban area, financial firms require in particular cognitive and social proximity, the former being related to the capacity of actors to share the same knowledge base and expertise, and the latter being related to the embeddedness of business relations and trust in a social context. However, as a small IFC, Luxembourg provides strong advantages in terms of both kinds of proximity: cognitive proximity is encouraged by the specialisation of the financial industry in certain products or operations, whereas social proximity is encouraged by the dense network of formal and informal relations developed between peers and/or competitors in the City, and between them and the political-regulatory sphere. As a partner in a London-based law firm argues: "We very much benefit from the support of service-sector institutions such as the CSSF and to professional bodies. (…) Of course, the entire legal and regulatory environment is a key feature for our firm. But proximity matters, especially when we have to discuss with ministries" (interview, 11 June 2007).

The development of the financial industry particularly benefited from the "access to a skilled labour supply". It appears that the well-educated and multilingual workforce of Luxembourg offers a true advantage when compared to other financial markets throughout the world.

Luxembourg has managed to create a sufficiently large labour pool possessing appropriate skills and which is attractive to institutions in Europe. When compared with other financial markets such as Dublin, Luxembourg does indeed offer interesting opportunities. The Luxembourg-based financial industry had resulted in the development of highly specialised regional cross-border labour pooling (Walther and Dautel, 2010). More than 150,000 commuters cross the border every day from neighbouring France, Germany, and Belgium, contributing to the rise of a functionally-integrated cross-border metropolitan area of around 800,000 inhabitants, comparable in size to Geneva or Basel, two other knowledge-intensive European metropolitan centres (Sohn, Reitel and Walther, 2009).

The ability to attract senior managers is an important issue in terms of diversification of activity and the development towards less back-office activities. In fact, core financial activities are organised in a very hierarchical and uneven way at the international level: as regards asset management, for example, the core business is still operated in a few large financial centres such as London, Paris and Zurich, for British, French and Swiss banks respectively. Being innovative in that kind of business is certainly important for Luxembourg if the city wants to develop more core activities in the value chain of the finance industry (Pieretti, Bourgain and Courtin, 2007). The bankers interviewed agreed that there was clearly a lack of experienced people, but they also recognised that the increasing international recognition of Luxembourg as a specialised financial centre makes recruitment somewhat easier than a decade ago, especially for young, highly motivated graduates.

Additional adaptation strategies

As shown above, adaptation to changing regulatory and market environments has been closely linked to various types of innovation. The fund industry, for example, has been

diversifying from traditional retail funds to alternative investment funds (such as private equity, property or hedge funds) over recent years. About 700 such funds were domiciled in June 2009, with a total of € 128.5 billion under management. A degree of uncertainty is currently affecting these funds, due to the proposed AIFM European Directive, which seeks to ensure that all investment fund managers are subject to harmonised regulatory standards (EC, 2009). Their funds will be authorised to operate under a passport system throughout the EU once they have been authorised in one country. As an alternative to Cayman or Bermuda funds, Luxembourg is expected to benefit from the new global supervision of alternative funds and the re-domiciliation trend. This could mark a certain convergence between hedge funds and UCITS funds, which are also evolving rapidly. In 2009, Luxembourg adopted the new UCITS IV directive to enhance the harmonised European regime for investment funds (Ernst & Young, 2010), which will make it possible for an investment fund to be managed by an investment company located in another country within the EU. The new directive is expected to lead to cross-border mergers between funds, and contribute to the rationalisation of the industry to the benefit of Luxembourg (interview, 21st April 2010).

More recently, and clearly as a reaction to the financial crisis, the state and its business development agencies have been strongly engaged in the quest for further diversification of products and (geographical) markets for the financial sector. To date, the two most promising emerging markets increasingly targeted by Luxembourg's fund industry are Islamic finance and microfinance.

Islamic finance

Islamic finance, i.e. the development and handling of Sharia-compliant financial products, in Luxembourg in fact goes back to 1983, with the first compliant insurance company in

Europe. More recently, this sector has been recognised as being one of the most promising emerging markets, in both geographical and in product terms. In geographical terms this is because, apart from the petrol-exporting countries in the Middle East, some of the most dynamic industrialising countries in south and south-east Asia (e.g. Malaysia, Indonesia) are Muslim countries whose citizens are experiencing increasing wealth leading to a considerable growth of Sharia-sensitive investment assets. The same is true for institutional investors (e.g. pension funds and life insurances) from these regions looking for alternative investment opportunities at the international level. From a product-engineering point of view, Islamic banking requires a thorough understanding of the specific investment strategies, obviously differing strongly between the various countries. Human resources and individual expertise are therefore considered to be the most critical issues within the Islamic asset management industry (Ernst & Young, 2008).

Today, Luxembourg is the largest non-Muslim Islamic fund domicile, representing 7% of global market share. All 40 funds – out of which 16 are listed as "sukuk" (bonds) on Luxembourg's stock exchange – recorded positive returns in 2009 (Lipper, 2010). While the total assets domiciled in Luxembourg amount to € 308 million, this sector admittedly still plays a minor role compared to the over € 2,000 billion of total assets under management in the country. Nevertheless, recent growth rates (e.g. 44% net asset growth between 2008 and 2009) show the potential of this sector.

These emerging activities are accompanied by a variety of measures taken by Luxembourg's government, such as establishing a taskforce to explore the development perspectives of Islamic banking and organising road shows in the various "client" countries within the framework of ministerial visits or of the promotional activities of the semi-public

development agency “Luxembourg for Finance”. While Luxembourg remains the leading centre for Islamic finance in Europe, other financial centres, such as London, Paris and Dublin, are currently positioning themselves by establishing favourable institutional and legislative environments for Islamic investments (HSBC, 2009).

Microfinance

In terms of net assets, the more recently-emerging sector of Microfinance Investment Vehicles (MIVs), with its almost US$ 3 billion domiciled in Luxembourg, is currently more important, as it is with regard to Luxembourg’s competitors. In 1998, Luxembourg was the chosen domicile of the first registered microfinance fund. Clearly, a particular setting providing both on the one hand, a strong civil society and public commitment to development cooperation, and, on the other hand, a competitive fund industry with its specific expertise and a favourable regulatory environment helped to establish MIVs and to attract foreign investors to domicile their funds in Luxembourg.

Today, seven out of the world’s ten largest MIVs are under management in Luxembourg, together accounting for around 45% of the world’s MIV assets (€ 1,675 million, +39.6% between 2008 and 2009). Given its role in international development cooperation, there is a strong government commitment, which is not only mirrored by the usually high public involvement in terms of assets, but also by Luxembourg’s efforts to establish a suitable environment for this particular industry. With the implementation of the Luxembourg Fund Labelling Agency (LuxFLAG) in 2006, an important certifying body supervising the MIVs’ compliance with internationally recognised standards was created. In addition, in May 2010, LuxFLAG and the US-based MicroRate agency started a joint venture called LUMINIS Microfinance, in order to establish a competitive body to collect, analyse and validate

information from the rapidly growing MIV sector, thus providing the labelling agencies as well as investors with reliable information about the MIVs' activities and development. In the same month, the new Home of Microfinance was inaugurated in a prestigious town house in the city centre, hosting Luxembourg's leading NGO in the field of microfinance (ADA – Appui au développement autonome), as well as the European Microfinance Platform, the Microinsurance Network, and the African Microfinance Transparency Forum. This publicly financed facility provides, in addition to office space, a library with an information centre and conference rooms. The European Microfinance Platform (e-MFP) organises the annual European Microfinance Week, during which it awards each year the European Microfinance Award to an institution based in a developing country for its efforts in the field of microfinance.

According to representatives of Luxembourg's microfinance sector, the further growth of the sector is simultaneously threatening its success, as already today the most important MIVs "suffer" from over-liquidity, i.e. they are currently experiencing difficulties in transferring the invested assets to adequate projects in the target countries, mainly due to a lack of staff capacities and expertise in the fields of evaluation, handling and implementation of microfinance tools, to the great disappointment of major investors (interview, 19th May 2010). If this situation continues, it threatens to damage the sector's reputation. Over-liquidity is one of the reasons why increasing attention is paid to the establishment of performance quality control instruments in order to avoid "black sheep" in the sector, and why the microfinance actors are extending their activities to other forms of Socially Responsible Investments (SRI). The latter include, for example, fund initiatives targeting small- and medium-sized enterprises in developing countries which are neither eligible for traditional microfinance tools nor usually able to obtain credit from the domestic banks. The

REGMIFA fund, established in 2009, for example, focusing on SMEs in sub-Saharan Africa, started with funding commitments of US$ 150 million.

Conclusion

This paper has examined the question of why some specialised IFCs have proven resilient to the recent financial crisis, and suggests that Luxembourg's development strategy has been comparatively successful for two main reasons.

Firstly, the increasing concentration of banks and financial services companies has over time created agglomeration economies and contributed to making Luxembourg one of the few global specialists in finance. Accordingly, the era of exclusive tax niche policies appears to be over. Even though Luxembourg was originally developed by a niche policy, there is growing empirical evidence that the city has generated its own "local buzz". Luxembourg seems to benefit from a diversified and qualified cross-border labour pool, which gives the financial centre an international status and contributes to explaining its dominance as a hub for cross-border fund distribution within Europe. Luxembourg also benefits from being a small environment, which means that national and regulatory institutions can be easily approached. Our results are consistent with previous studies, which highlight the importance of agglomeration effects and show that the growth of the financial sector produces a significant increase in business services and non-financial market services (Bourgain and Pieretti, 2006).

Secondly, the development of the financial industry in Luxembourg shows that a strategy of continuous innovation has been adopted to maintain the comparative competitiveness of the financial centre. This "first mover" strategy has enabled Luxembourg to adopt quickly a

number of new European regulations, while maintaining distinctive advantages (including banking secrecy). It remains true, however, that the main drivers of the financial sector remain the investment fund industry and private banking. Strategies designed by public and private actors to develop alternatives, such as Islamic finance and microfinance, are still very limited in terms of assets under management. Nevertheless, these two emerging activities appear to be strongly reliant on the specific local context both in terms of institutional environment as well as in terms of location-specific expertise.

The aftermath of the financial crisis shows that Luxembourg is navigating a narrow path. On the one hand, most of the actors in the financial sector are aware that, because of European and international regulatory pressure, approaches to risk management will have to be re-assessed, transparency improved, clients' needs taken even more seriously, and more rigorous controls implemented. But, on the other hand, Luxembourg remains highly dependent on the skills that have allowed it to be successful (Falk, 2009). As recently expressed by Minister for Finances Luc Frieden at the Stock Exchange Day 2010, local actors also would like to "remain what they are" – which is the national motto ("Mir wëlle bleiwe wat mir sin"), painted on an ancient house in medieval Luxembourg City.

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