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Executive summary

In September 2014 people in Scotland will take one of the most important decisions in the history of Scotland and the whole of the United Kingdom (UK) – whether to stay in the UK, or leave it and become an independent state. In advance of the referendum the UK Government will ensure, through the Scotland analysis programme, that the debate is properly informed and that the facts that are crucial to considering Scotland's future are set out.

As explained in the first Scotland analysis paper, *Devolution and the implications of Scottish independence*, in the event of a yes vote, in the eyes of the world and in law, Scotland would become an entirely new state, separate to the rest of the UK. The UK Parliament would remain sovereign in the continuing UK. So the UK's key national institutions, for example the Bank of England, would operate on behalf of the continuing UK as before.

The second Scotland analysis paper, *Currency and monetary policy*, explained that the currency and macroeconomic framework that operates across the UK would not be able to continue between two separate states. Of direct relevance to financial services, it raised the question of how and whether lender of last resort facilities could work in an independent Scotland. And how and why a central bank from one state, such as the Bank of England, could step in to provide financial support to the banks or financial sector of another state. For this and other reasons, the paper explained that the economic rationale for the UK to agree to enter a formal sterling union with a separate state is not clear.

In the event of a vote for independence, there would be further consequences for the financial sector and for its customers – all individuals and businesses – which are analysed in this paper. The most profound implication is that independence would create two separate financial jurisdictions: the continuing UK and a new, independent Scotland, which would require its own legal and regulatory framework.

The financial services sector of the UK and Scotland

Together, Scotland and the rest of the UK have a large and successful financial services industry, which is respected across the world. It provides the banking and investment services that individuals, households and businesses rely on every day; life and general insurance for protection when things go wrong; and pensions and long-term savings products to support people in their old age.

The financial services sector remains one of the most important industries in Scotland and the rest of the UK. Financial services contributed £8.8 billion to the Scottish economy in 2010 – more than eight per cent of Scottish onshore economic activity.[1] The sector directly employs

[1] See ONS Regional accounts at www.ons.gov.uk/ons/rel/regional-accounts

85,000 people in Scotland and a further 100,000 indirectly – around seven per cent of total Scottish employment.[2] The UK is widely recognised as a global leader in financial services. Scotland's vibrant financial sector is an important contributor to this strong UK position, and also benefits from its global reputation.

A large, internationally competitive financial sector

As part of the UK, Scotland is a strong and attractive location for financial services business. These strengths have developed over the past 300 years, with a long history of successful Scottish innovation. For example, the Scottish Ministers' Widows Fund (founded in 1748) was the first company ever to provide life insurance.[3] Leading figures from the financial services industry cite Scotland's reputation, as well as the skills of the workforce and the high quality of Scottish universities, as key reasons to locate their businesses in Scotland.[4]

The competitiveness of Scotland's financial sector is aided by its location within the UK. Industry and international bodies view the UK as a strong tax and regulatory regime, building customers' and partner organisations' trust in UK financial firms. The Global Financial Centres Index (GFCI) rates London as the most competitive international financial centre,[5] scoring particularly strongly on regulation and the quality of people. International investors know and value the fact that large financial firms based in Scotland will share the City of London's UK-wide regulatory framework, in which banks are overseen by the Bank of England under UK law. Being part of the UK helps support the Scottish financial services sector, which generates employment not just in financial services firms, but in the professional and other services that support the sector. For example, over 40 per cent of Scottish postal services and nearly 30 per cent of Scottish accountancy services are sold to the Scottish financial sector.[6]

As well as the advantages of being headquartered in (and operating out of) Scotland, Scottish financial services firms also benefit from the UK's stability and markets' confidence in the larger UK economy. The UK-wide regulatory framework, which maintains the stability of the financial system, is vital to all firms that operate in the UK. Location in a larger economy also helps to reduce firms' cost of borrowing because markets perceive these firms as less of a risk.

Scotland's financial sector currently enjoys the best of both worlds: its size and historic strengths and specialism helps to create wealth and jobs in Scotland; while being part of the UK gives regulators, firms and individuals confidence in managing financial risk. If Scotland became independent, this position would be called into question:

- The Scottish banking sector would be exceptionally large compared to the size of an independent Scotland's economy, making it more vulnerable to financial shocks than it is as part of the larger UK. The assets of the whole UK banking sector (including Scotland's banks) are around 492 per cent of total UK GDP.[7] This is large by international standards, but as the financial crisis showed, still manageable. By contrast, Scottish banks have assets totalling around 1254 per cent of an independent Scotland's GDP.[8] In comparison, at the end of 2007, Icelandic banks had assets

[2] All data from *Regional Contribution of UK Financial and Professional Services*, The City UK, January 2013

[3] See *Scottish Financial Enterprise – Facts*, available at www.sfe.org.uk/facts.aspx

[4] *Scottish financial sector remains resilient*, Financial Times, 4 January 2012.

[5] *The Global Financial Centres Index*, Z/Yen, September 2012, page 33.
available at www.zyen.com

[6] *Financial centres in peripheral regions: the effect of the financial services industry on regional economy. The case of the Scottish financial cluster*, Mikel Larreina, June 2008, p.21.

[7] HM Treasury analysis of FSA regulatory data available at www.gov.uk/scotlandanalysis

[8] HM Treasury analysis of FSA regulatory data available at www.gov.uk/scotlandanalysis

equivalent to 880 per cent of GDP[9] – a major contributor to the cause and impact of the financial crisis in Iceland. Cyprus, which has had serious financial difficulties more recently, has total banking assets around 700 per cent of GDP;[10] and

- The banking sector in an independent Scotland would be dominated by the two largest banks – the Bank of Scotland and the Royal Bank of Scotland (RBS). There could be questions about an independent Scotland's ability to stabilise its banking system in the event of a future financial crisis. In 2008, the UK Government spent £45 billion recapitalising the RBS in order to protect the deposits and savings of households and small business. In addition, the bank received £275 billion of guarantees through the UK Government's Asset Protection Scheme. This combined support from the UK Government to RBS is equivalent to some 211 per cent of Scottish GDP in 2008.[11]

The size of the UK economy relative to its financial sector means that even if a very large firm fails, the UK Government can intervene to ensure that consumers and businesses are protected. The UK has credible institutions, such as the Bank of England, which acts as lender of last resort for the UK financial system.

The exceptionally large and highly-concentrated financial sector of an independent Scotland would be likely to increase the risks, to markets, firms and consumers, of financial services firms operating in an independent Scotland. As a result, if Scotland were to become independent, there are two potential alternative consequences for the financial sector:

- First, if the large banks made no changes to their group structure and kept their existing headquarters, an independent Scotland would have an exceptionally large financial sector. Concerns about financial stability could raise questions: for the firms themselves; for markets that finance those firms; and for an independent Scottish state, which would have to consider what resolution mechanisms to put in place. The recent financial crisis and the ongoing difficulties for banks in parts of the euro area highlight these challenges, and the economic and fiscal difficulties that a large financial sector can create for a sovereign state; and
- Second, where large firms are faced with greater concentration or risk they may look to diversify or restructure themselves for example so that they were no longer headquartered in Scotland. If this were to happen it could undermine Scotland's current status as an important financial centre.

A single, integrated domestic market across Scotland and the rest of the UK

Scotland and the rest of the UK benefit from a large domestic market in financial services with no restrictions on buying and selling financial products across the UK. The Scottish financial services industry estimates that 90 per cent of its customers are located in the rest of the UK, and the market is highly integrated for most financial products.[12] For example, 89 per cent of

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9 *Economic Survey of Iceland 2009: The financial and economic crisis*, OECD, September 2009, page 5.

10 See interactive map: European banking markets at www.dbresearch.com

11 Figures for the Scottish nominal GDP taken from Scottish Government statistical release, available at www.scotland.gov.uk. The figure for the peak cost of the UK Government's interventions is £1,162.19 billion. This figure is available from the NAO (www.nao.org.uk). The figures for interventions in relation to RBS are Treasury figures, drawing on figures provided by RBS in their audited accounts in relation to the repayment of the special liquidity scheme.

12 Speech by Owen Kelly, Chief Executive of Scottish Financial Enterprise at the Scotsman Conference, *A Question of Independence: The Economics of Independence*, June 2012.

stocks and shares Individual Savings Accounts (ISAs) provided by Scottish firms are sold to customers based in the rest of the UK, and 33 per cent of the Individual Savings Accounts (ISAs) opened by Scottish consumers were with non-Scottish firms.[13] If Scotland became independent, it would put an international border in the middle of these transactions.

The high level of integration across the UK benefits businesses and consumers in Scotland and the rest of the UK. The greater size of the UK market means that firms can spread both funding and risk across a population of 60 million people. More firms and greater competition provides customers with a far greater choice of financial products at a lower cost.

Scottish independence would break-up the current UK domestic market. There is currently a single regulatory framework covering the whole of the UK, but this could not continue if Scotland became a separate state. Crucially, if an independent Scottish state became a member of the EU it would be required to establish its own financial regulator.

Independence would create separate regulatory and tax regimes under separate governments. These regimes would be likely to diverge over time; creating barriers to trade that do not currently exist. International experience shows that borders reduce flows of products, money and people.[14] This happens even in single market areas like the EU, with low formal trade barriers. Creating an international border would reduce financial firms' ability to spread risk, and potentially drive up the cost of financial products for Scottish households.

If Scotland were to become independent, new barriers to business could have a direct impact on individuals' personal finances, including for:

- **Bank accounts:** experience in the Republic of Ireland shows that, where a large number of financial transactions take place across an international border, this can create additional costs on both sides of the border, notably because: the banks or the states operate different polices; customers do not benefit from economies of scale; and if there is a different currency;[15]
- **Pensions:** where 70 per cent of all pension products bought by Scottish consumers are from firms based in the rest of the UK.[16] Work by the Institute of Chartered Accountants Scotland (ICAS)[17] shows that if Scotland were to become independent "the potential impact on funding requirements for employers operating defined benefit or hybrid schemes across the UK is likely to be substantial." In addition, the Pension Protection Fund, which offers compensation to defined benefit pension schemes affected by insolvencies operates on a UK-wide basis and may need to be replicated in an independent Scotland;
- **Savings:** where products are currently regulated, taxed and marketed on a common UK-wide basis. This would be fragmented in the event of independence and the emergence of separate financial jurisdictions. For example 48 per cent of adults in Scotland currently have an ISA, which attract UK tax relief. ISAs would cease to be available in the current form if Scotland separated from the rest of the UK and the Scottish Government would need to put in place its own arrangements if it chose to replicate this;

13 HM Treasury analysis of FSA product sales data for the financial year ending March 2012, available at www.gov.uk/scotlandanalysis

14 *National Borders Matter: Canada-US Regional Trade Patterns*, McCallum, 1995.

15 See compare.nca.ie/Current Account and *A guide to Fees and Charges for Personal Accounts,* AIB, July 2012. Chapter 4 explores these issues in more detail.

16 HM Treasury analysis of FSA product sales data for the financial year ending March 2012, available at www.gov.uk/scotlandanalysis

17 *Scotland's Pensions Future: What Pensions Arrangements Would Scotland Need?* ICAS, April 2013.

- **Motor insurance and other insurance products:** which are designed to dovetail with and supplement the legal, regulatory and welfare systems of a state. This means that, currently, insurance products can be sold across the whole UK. However, in the event of Scottish independence, where differences may emerge in legal and regulatory frameworks, this could require different products and potentially additional costs; and
- **Mortgages:** where it is rare for mortgages to be sold across borders given the complications of operating across the differing tax, regulatory and legal systems of different states.[18]

Protecting consumers

The UK has established effective arrangements for protecting consumers of financial services. These ensure that customers benefit from consistent standards and fair treatment across the whole UK. An independent Scottish state would need to establish its own financial consumer protection because of EU requirements that Member States have their own schemes for protecting customers' deposits.[19]

The UK's Financial Services Compensation Scheme (FSCS) pays compensation to savers if their banks fail. It guarantees consumer deposits in a UK bank up to £85,000. The scheme, and any compensation payouts, is funded through charges on the banks and financial firms that are covered by the FSCS. Across the whole UK a very large number of firms are included. This means that the burden of funding the FSCS is spread across many firms. The FSCS is also backed by the UK Government's established and broad fiscal base, which can provide short term funding to the scheme if needed. The UK Government lent £20 billion to the FSCS during the recent financial crisis. A financial compensation scheme in an independent Scotland would cover far fewer firms, and would be dominated by two large banks. If one of those banks were to fail any similar scheme would struggle to compensate savers.

Conclusion

Scotland has a strong and vibrant financial services industry. As part of the UK, firms and individuals benefit from a world-leading financial services sector and a large, integrated domestic market for financial services, with clear and effective arrangements for protecting consumers. This position would be put at risk if Scotland were to become independent, fragmenting the market and the bodies that have been put in place to protect customers.

[18] *White Paper on integration of EU mortgage credit markets*, Commission of the European Communities, December 2007.

[19] Under the EU Deposit Guarantee Schemes Directive (see ec.europa.eu/internal_market/bank/guarantee/)

Introduction

Before the end of 2014, people in Scotland will take one of the most important decisions in the history of Scotland and the whole of the United Kingdom (UK) – whether to stay in the UK, or leave it, and become a new, separate and independent state. It is important that the debate leading up to the referendum is informed by analysis, and that the facts that are crucial to considering Scotland's future are fully set out. The UK Government believes that Scotland is better off as part of the UK, and that the UK is stronger with Scotland as part of it.

The onus is on those who want Scotland to leave the UK to set out their proposals for independence and address some of the key questions relating to its implications. Not all of the answers to these questions can be known in advance of the referendum. This is because some of the detail can only be established through negotiations between the representatives of an independent Scottish state, the continuing UK,[1] and other bodies, for example the European Union (EU). These negotiations would have to take place in the event of a vote for Scottish independence.

The objective of the UK Government's Scotland analysis programme is to provide comprehensive and detailed analysis of Scotland's place in the UK and how that would be affected by independence. The output of the analysis will provide sources of information that will enhance understanding on the key issues relating to the referendum. As such the programme should be a major contributor to the independence debate.

This paper, the third in the Scotland analysis programme, considers the way in which current UK structures support the financial services sector in Scotland and the rest of the UK; and the implications for the industry and the wider public if Scotland were to become independent.

The performance of the financial services sector in Scotland and the rest of the UK is closely linked to wider economic and fiscal performance, both through the sector's role in supplying credit to households and businesses, and because of the severe effects on the economy that can result if the sector does not function efficiently and effectively. Chart 0A sets out the four components of the existing UK framework that are considered in the four chapters of this paper.

1 Under the current arrangements, the UK without Scotland (i.e. England, Wales and Northern Ireland) is referred to as the "rest of the UK". When discussing possible implications in the event of independence, the UK without Scotland is referred to as the "continuing UK".

Chart 0A: The components of the UK framework

Source: HM Treasury

These four components are closely interrelated. Protecting the interests of households and businesses requires a contested and transparent market in financial services, in which markets operate fairly to deliver value for consumers. It also requires effective arrangements to manage the risks posed by the banking system, for example a properly funded compensation scheme, which can ensure that depositors are protected if their bank or building society runs into financial difficulties. Maintaining a competitive business environment needs customers and counterparties of financial services firms to have confidence in the economic and regulatory environment. It also requires that firms are able to reach their customers easily, and that barriers to entry and exit in the market are minimised. All countries with a developed financial sector face these challenges – not least the UK, which is currently undertaking major reforms in response to the financial crisis that began in 2008.[2]

The following chapters consider: the key elements of a successful financial sector in Scotland and the rest of the UK; how current and planned UK structures support those elements; and; the challenges that would arise if Scotland became independent and sought to maintain those elements.

The scope of this paper

The data on which this analysis is based are set out in the statistical annex to this paper, and are also available to download from www.gov.uk. This paper limits itself to conclusions that can be drawn from the currently available information (including statistical data and legal analysis) and, where relevant, economic theory and international examples. This means that there are two key issues that while important to the debate, are not within scope: first, the detailed implications of particular policy decisions that the government of an independent Scotland might wish to pursue; and second, issues around EU membership negotiations for an independent Scotland and the possible impact of any disruption during any period of transition to EU membership.

[2] See www.gov.uk/government/topics/financial-services

Although the analysis considers various policy options that would be available should Scotland become independent, the conclusions do not attempt to anticipate final decisions, some of which could depend on the outcome of political negotiations between representatives of the continuing UK and a new Scottish state. For example, if RBS were still in public ownership, it is likely that there would need to be consideration given to the UK Government's stake, as part of a much wider negotiation of assets and liabilities. This in turn could have implications for any decision over domicile taken by the bank itself. Owen Kelly, Chief Executive of Scottish Financial Enterprise (SFE) told the House of Lords Economic Affairs Committee in October 2012: "We do not speculate on what might be decided in an independent Scottish state, since we do not think that is knowable at this stage, and we treat with caution all assertions on either side of the argument that are necessarily based on beliefs and expectations about the actions in future of a hypothetical polity rather than on hard facts and evidence."[3] This analysis follows that principle. Although policy choices are highlighted, the conclusions stand whatever policy the government of an independent Scotland might choose to adopt.

As set out in the UK Government's paper, *Devolution and the implications of Scottish independence*, the issue of an independent Scotland's EU membership is particularly significant and complex. Should Scotland become independent, the UK's EU membership would continue automatically. For an independent Scottish state, negotiations would be needed. Rather than being purely a matter of law, the mechanism for an independent Scottish state to become a member of the EU would depend on the outcome of these negotiations and on the attitude of other EU institutions and Member States. It is likely to be a process requiring unanimity across all Member States of the EU. Since an independent Scotland would be a new state there is a strong case that it would have to go through some form of accession process to become a member of the EU. This is the view expressed by the President of the European Commission.[4]

However, because these factors are highly dependent on political negotiations and on the other currently "unknowable" factors, this analysis considers the implications of independence for the Scottish financial sector on the hypothetical basis that an independent Scottish state would eventually succeed in negotiating membership of the EU.

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3 See the evidence from Owen Kelly, Chief Executive of Scottish Financial Enterprise, to the House of Lords Economic Affairs Committee on 24 October 2012 available at www.parliament.uk/business/committees

4 *Scotland analysis: Devolution and the implications of Scottish independence*, HM Government, February 2013, page 8, available at www.gov.uk/scotlandanalysis

Chapter 1:
Managing financial sector risk

Scotland and the rest of the UK have a financial services sector with prestige and global presence.

The current constitutional setup ensures that the Scottish public benefits from historic Scottish strengths in financial services, as well as UK protection and regulation as part of a global financial market. Scotland maintains a large and successful financial services sector, which creates Scottish jobs and contributes to Scottish GDP, as well as driving economic growth. At the same time, Scotland is part of the larger UK: there is a consistent UK-wide regulatory framework for managing stability risks to the financial system as a whole, which is vital in view of the fact that many firms operate on a UK-wide basis. The size of the UK economy relative to its financial sector means that it is in a position to coordinate the resolution of failing firms, and to stand behind any resolution arrangements.

The current constitutional setup also supports firms and the sector. Firms retain the distinct advantages of being headquartered in (and operating out of) Scotland. However, they also benefit from the wider stability and market confidence that comes from being based in a larger state. The UK, of course, also benefits from a strong and vibrant Scottish financial sector as part of its relative strength in financial services compared to Europe and the wider world, and would be worse off without it.

If Scotland were to become independent, it could no longer enjoy this best of both worlds position. There are two possible outcomes. The first is that the large financial services sector could remain structured broadly as it is currently, with the headquarters of major banks remaining in Scotland. In this case:

- **the Scottish banking sector would be oversized, with assets totalling around 1250 per cent of Scotland's GDP.** By way of comparison, before the crisis that hit Cyprus in March 2013, its banks had amassed assets equivalent to around 700 per cent of its GDP – a major contributor to the cause and impact of the financial crisis in Cyprus and the ability of the Cypriot authorities to prevent the systemic effects when it hit;

- **because of the size of individual firms relative to Scotland's GDP, under independence the sector itself would pose a significant risk to Scottish taxpayers.** The UK Government spent £45 billion recapitalising Royal Bank of Scotland (RBS) in order to protect the deposits and savings of thousands of households and small businesses. In addition, the bank received £275 billion of state support in the form of guarantees and funding. In total, this would have been equivalent to 211 per cent of Scotland's GDP, even allocating Scotland a geographical share of North Sea oil. By contrast, total UK interventions across the whole banking sector amounted to almost £1.2 trillion, or 76 per cent of whole UK GDP;
- **these factors would be likely to mean that Scottish firms would be perceived as more risky, which could drive up funding costs for Scottish banks;** and
- **it would also place limitations on the fiscal policy pursued by any future government of an independent Scotland.** The experience of small countries with large financial sectors which have been successful in avoiding the worst consequences of the recent financial crises suggests that a very prudent fiscal policy and a large current account surplus have played an important role in sheltering these economies.

The second possible outcome of independence is that the Scottish sector would reduce in size and status. This would happen if firms themselves react to the heightened risk by structuring themselves such that they were no longer headquartered in Scotland (as has recently been suggested by independent commentators).[1] This could undermine the status of Scotland as an important financial centre, and weaken the financial services "cluster" discussed in Chapter 2.

The Scottish financial services industry has developed in the context of a single fiscal union across the UK. In the event of independence this fiscal union would end with the potential implication that either the size of the sector may reduce (with negative effects on employment, GDP, and the provision of banking services), or that firms, taxpayers and consumers would likely be required to absorb any costs associated with heightened risks to financial stability.

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1 See *Scottish financial structure*, Charles Goodhart in Andrew Goudie (ed) *Scotland's Future – the economics of constitional change*, 2013.

The financial services industry in Scotland

1.1 Together, Scotland and the rest of the UK have a large and successful financial services sector with prestige and global presence. Scotland's strength in financial services dates back over 300 years, with a long history of successful innovation. The Bank of Scotland was established in 1695 not to supply the Government with credit, as was the case with the Bank of England and other national banks, but to meet the needs of households and businesses.[1] The Scottish Ministers' Widows Fund, founded in 1748 by two Scottish clergymen, Wallace and Webster, was the first company ever to provide life insurance.[2]

1.2 Scotland has many significant advantages as a place for doing business. In particular, firms cite the skills of the workforce, drawing on high quality graduates from Scottish universities. This has helped attract firms such as Morgan Stanley, which is currently developing Glasgow as an on-shore strategic support hub,[3] as well as Barclays[4] and others. Jayne-Anne Gadhia, chief executive of Virgin Money, says that "Scotland has a solid reputation for financial services and of course has highly talented and skilled people to help us grow the Virgin Money business." These factors have helped to maintain the resilience of the financial sector in Scotland, despite the significant economic and reputational consequences of the financial crisis that began in 2008.[5]

1.3 The financial sector is crucial to the Scottish economy. In 2010, financial and insurance activities contributed £8.8 billion to Scotland's economy, accounting for more than 8 per cent of Scottish onshore activity.[6] Recent figures from The City UK show that the sector employs 84,800 people directly,[7] around three per cent of total Scottish employment, as well as a further 100,000 indirectly.[8] Financial and associated professional services in Scotland employ a total of 148,600 people, 6.1 per cent of total Scottish employment, contributing over £14 billion to the economy, 13.1 per cent of Scottish GDP.[9] These figures illustrate just how significant financial services are to Scotland's employment and its economy. Despite recent challenges, the financial services industry in Scotland remains vibrant. One of the key reasons for this is that it does not stand alone, but as an important part of the wider UK domestic market.

Sector	proportion of total Scottish financial sector employment	Scottish financial sector employment as a proportion of total UK financial services employment
Banking	46.5%	8.7%
Insurance	30.3%	8.1%
Fund Management	4.2%	11%
Securities Dealing	4%	5.3%
Other	15%	6.2%

Table 1A: Financial services in Scotland

Source: *Regional Contribution of UK Financial and Professional Services*, The City UK, January 2013

1 *Financial centres in peripheral Regions: the effect of the financial services industry on regional economy. The case of the Scottish financial cluster*, Mikel Larreina, June 2008, page 17.

2 See *Scottish Financial Enterprise – Facts*, available at www.sfe.org.uk/facts.aspx

3 *600 Morgan Stanley jobs to be created in expansion*, The Herald, 11 July 2007.

4 *Barclays creates up to 600 jobs in Glasgow*, The Herald, 5 September 2010.

5 *Scottish financial sector remains resilient*, Financial Times, 4 January 2012.

6 See ONS Regional accounts at, www.ons.gov.uk/ons/rel/regional-accounts

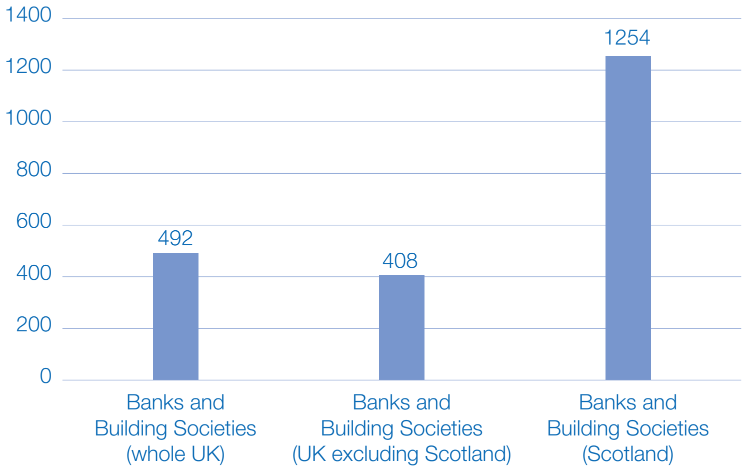
7 *Regional Contribution of UK Financial and Professional Services*, The City UK, January 2013.

8 See *Scottish Financial Enterprise – Facts*, available at www.sfe.org.uk/facts.aspx

9 *Regional Contribution of UK Financial and Professional Services*, The City UK, January 2013.

1.4 Banking is the biggest provider of employment in the Scottish financial services sector. However, the Scottish life and pensions sector is particularly significant for the rest of the UK: 24 per cent of employment in the UK life and pensions sector is based in Scotland.[10] Within the financial services sector, banking is also the largest contributor to the Scottish economy, contributing over £4 billion, again accounting for nearly half of the total financial services contributions.[11] As show in Chart 1A, the Treasury estimates that the assets of Scottish banks are around 1250 per cent of Scotland's GDP.[12]

Chart 1A: Banking sector assets relative to GDP in an independent Scottish state



Source: HM Treasury analysis of FSA data

1.5 Scotland has historically been a centre for asset management, with an estimated £750 billion of assets under management[13] and an estimated 3,600 people employed (directly and in ancillary services). The Scottish share of the UK asset management sector increased from 5.6 per cent in 2009 to 6.4 per cent in 2010. The Treasury estimates that there are around 80 investment firms in Scotland,[14] including the headquarters of two of the UK's largest: BlackRock International Ltd (the largest in the UK) and Standard Life Investments (the ninth largest). Scotland is also a centre for fund administration, with strong corporate links with firms based in London and elsewhere.

1.6 The Scottish financial services sector is an important industrial cluster,[15] which has seen strong growth within a geographical area that has facilitated the development and success of the industry. Scotland's financial services are clustered primarily along the "central belt" from Glasgow to Edinburgh, although Dundee, Stirling, Aberdeen and Perth also host significant financial services employers. The City UK record that of the 148,600 people employed in financial and associated professional services in Scotland, 55,100 are based in the Edinburgh metropolitan area and 48,800 based in the Glasgow metropolitan area.

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[10] See *Scottish Financial Enterprise – Facts*, available at www.sfe.org.uk/facts.aspx.

[11] *Regional Contribution of UK Financial and Professional Services*, The City UK, January 2013.

[12] This figure is based on a measure of Scottish GDP including geographical share of North Sea oil. Others have suggested higher figures for the size of the Scottish financial sector relative to GDP (see *The Economic Implications for the United Kingdom of Scottish Independence*, House of Lords Select Committee on Economic Affairs, 2013, p.9)

[13] See *Scottish Financial Enterprise – Facts*, available at www.sfe.org.uk/facts.aspx

[14] 82 firms, based on the number of firms in the FSA register whose primary category is listed as "Discretionary Investment Manager".

[15] The cluster effect is discussed in more detail in Chapter 2, and refers to the fact that proximity to other similar industries brings a competitive advantage.

Box 1A: Defining the Scottish financial services sector

The Scottish financial services sector has developed over the three hundred years since the Acts of Union on the basis of a single UK-wide environment, and firms operate on a UK-wide basis.

If Scotland became independent, the group structure of these companies would become crucial, as it would determine who (an independent Scotland or the continuing UK) would be responsible for regulating these firms, and for resolving them if they fail. Charles Goodhart, professor at London School of Economics and a former member of the Bank of England's Monetary Policy Committee (MPC), argues that "The main banks in Scotland have now become, in effect, headquartered abroad" and that therefore regulation and resolution of these firms would fall to the continuing UK authorities in the event of independence.[1]

However, this would require Scottish banks to make changes to their group structure by moving their headquarters out of an independent Scotland. For example, Lloyds Banking Group (LBG) is headquartered in London, but Bank of Scotland (part of LBG) is a separate subsidiary which is headquartered in Edinburgh. If Scotland were a separate country, responsibility for regulating and resolving the Bank of Scotland would lie with Scottish authorities, unless Bank of Scotland itself relocated its head office to London or elsewhere in the UK (or if the group restructured so that it had separate subsidiaries in Scotland and the rest of the UK).

This chapter does not attempt to anticipate what commercial decisions may be taken by firms should Scotland become independent. The analysis of financial risk in this chapter therefore assumes that the sector remains structured as it is. Firms whose headquarters or "principal place of business" are in Scotland are to be considered "Scottish" firms, including firms such as Clydesdale. When considering groups, legal entities are treated on an individual basis, rather than the whole group being classified as either Scottish or "rest of the UK". For example within RBS group, Royal Bank of Scotland PLC is treated as a Scottish firm, but National Westminster Bank PLC is treated as a "rest of the UK" firm: although it is part of RBS group, it is separately authorised and headquartered in London. This applies to all instances in this paper of Treasury analysis based on FSA regulatory data.

This approach has been taken on the basis that if such firms did not move their headquarters in the event of independence, they would need to be authorised and supervised by the Scottish regulator.

[1] *Scottish financial structure*, Charles Goodhart in Andrew Goudie (ed) *Scotland's Future – the economics of constitutional change*, 2013, page 150 and 152.

The UK framework for maintaining confidence and stability

1.7 The current constitutional setup ensures that the Scottish public benefits from historic Scottish strengths in financial services, as well as UK protection and regulation as part of a global financial market. As discussed above, Scotland maintains a large and successful financial services sector, which creates Scottish jobs and contributes to Scottish GDP as well as driving economic growth. At the same time, Scotland is part of the larger UK. There is a consistent UK-wide regulatory framework for managing stability risks to the financial system as a whole. The size of the UK economy relative to its financial sector means that the UK authorities are in a position to effectively coordinate the resolution of failing firms, and to stand behind any resolution arrangements.

1.8 With the large financial sector that exists in Scotland and the rest of the UK, it is vital to have an effective framework for maintaining confidence in the sector and UK's financial stability. Under the current constitutional set up, Scottish banks and other financial services firms retain the distinct advantages of being headquartered in (and operating out of) Scotland. However, they also benefit from being based in the UK.

1.9 As the analysis in this chapter demonstrates, an independent Scottish state would no longer be able to enjoy this best of both worlds position. It would be unable to resolve a significant banking crisis without severe fiscal consequences. Furthermore the size of the banking sector could adversely affect market perceptions of the vulnerability of both sovereign and sector, and consequently their ability to borrow cheaply.

The single UK regulatory framework for addressing financial risks

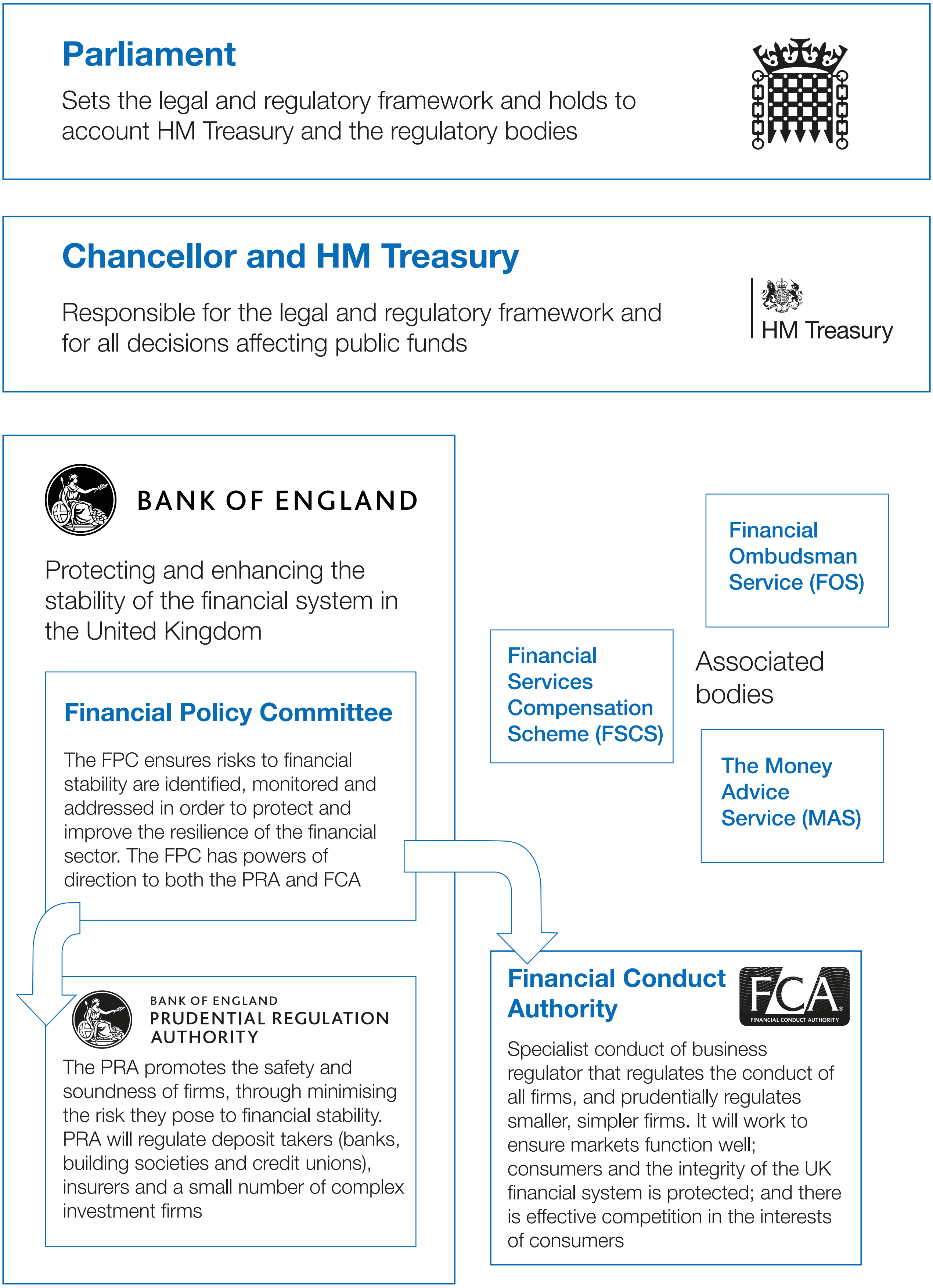
1.10 The financial crisis that started in 2008 was caused by the failure of financial institutions to manage themselves prudently, and of regulators to spot the risks that were building up across the system as a whole. Governments internationally are continuing to deal with the fiscal and economic consequences of these major banking failures.

1.11 There is currently a UK-wide framework for managing risks to financial stability, outlined in Chart 1B. This was put in place by the Financial Services Act 2012 which implements these reforms by:

- establishing a macro-prudential authority, the Financial Policy Committee (FPC) within the Bank of England, to monitor and respond to systemic risks;
- clarifying responsibilities between the Treasury and the Bank of England in the event of a financial crisis by giving the Chancellor of the Exchequer powers to direct the Bank of England where public funds are at risk and there is a serious threat to financial stability;
- transferring responsibility for significant prudential regulation to a focused new regulator, the Prudential Regulation Authority (PRA), established as a subsidiary of the Bank of England; and
- creating a focused new conduct of business regulator, the Financial Conduct Authority (FCA), which will supervise all firms to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants.

1.12 These structures allow for a consistent UK-wide regulatory framework for managing stability risks to the financial system as a whole – vital to ensuring that an effective "whole-of-system" approach to risk management in the UK-wide financial sector can be taken.

Chart 1B: The UK's financial stability framework



Source: HM Treasury

The UK's ability to resolve specific threats to financial stability

1.13 Under the current constitutional setup the UK is able to deploy its fiscal strength to resolve serious threats to financial stability, whether they arise in Scotland or in any other part of the UK. The Bank of England is responsible for financial stability for the UK as a whole and has the ability to act as a lender of last resort and provide liquidity to prevent a financial crisis. In addition to the Bank's standard lender of last resort operations, coordinated action between the central bank and the UK Government may be needed in the event of a crisis.

Royal Bank of Scotland (RBS) and Lloyds HBOS

1.14 Such a crisis erupted in 2008, resulting in the recapitalisation of RBS and Lloyds HBOS. In this case, the UK Government was able to deliver a single, coordinated response that mitigated the significant harm that could have been caused to individuals, businesses and the wider UK economy by the collapse of these banks. The UK Government spent £45 billion recapitalising RBS in order to protect the deposits and savings of thousands of households and businesses. In addition, the bank received £275 billion of state support in the form of guarantees and funding. In total, this would have been 211 per cent of Scotland's GDP, including the geographical share of North Sea Oil.[16] As a range of independent commentators have noted,[17] Scotland would not have been able to afford such interventions alone. Other countries such as Ireland, Iceland and more recently Cyprus were unable to absorb the implications of the financial crisis on their own. By contrast, total UK interventions across the whole banking sector were almost £1.2 trillion or 76 per cent of whole UK GDP.

1.15 Had RBS and Lloyds HBOS been allowed to fail in a disorderly manner, there would have been an immediate and significant impact. Over 200,000 jobs would have been lost immediately in those two firms, nearly 45,000 of them in Scotland. There would have been a significant wider impact to the rest of the economy; for example, businesses supplying services to the banks would also have been affected.

1.16 Given the concentration of the Small and Medium Sized Enterprise (SME) lending sector, it is also likely that there would have been a severe impact on the supply of credit to small businesses. In 2011, Lloyds provided 36 per cent of finance to Scottish SMEs and RBS 34 per cent.[18] Failure of both banks would have resulted in the loss of 70 per cent of funding for small and medium sized enterprises in Scotland. Although other providers of credit may eventually have been found, SMEs would have experienced severe cash-flow difficulties in the short to medium term.

Dealing with future threats to stability

1.17 If faced with a future crisis on the scale of 2008, the UK Government would again have a crucial role to play in coordinating the response; and, if necessary, deploying its fiscal resources to resolve or reduce threats to financial stability. The UK Government agrees with those who argue that action is needed to address the "too big to fail" problem. Stephen Boyd of the Scottish Trades Union Congress (STUC) told the Lords Economic Affairs Committee: "From the STUC's perspective, if Scotland was no longer to have,

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16 The division of assets and liabilities, including North Sea oil, would be subject to negotiation following the referendum in the event of independence.

17 See the evidence to the House of Lords Economic Affairs Committee, available at www.parliament.uk/business/committees

18 *SME Access to Finance 2012*, Office of the Chief Economic Adviser, June 2012. Available at www.scotland.gov.uk

under any constitutional scenario, a too big to fail financial institution, that would not necessarily be a bad thing."[19] As set out in Box 1B, the UK Government is implementing a range of measures to minimise the possibility that taxpayers will be required to contribute in the event of a large banking failure.

1.18 However, it will remain the case that the size of the UK economy relative to its financial sector means that it is in a position to coordinate the resolution of failing firms effectively, and to stand behind any resolution arrangements. Resolving large banking failures with confidence is likely to be impossible unless there is a strong and large fiscal base underpinning actions to mitigate financial risk. For example:

- the Bank of England typically requires an indemnity from the Treasury in order to offer Extraordinary Liquidity Assistance (ELA) to a firm in serious financial difficulties. This is because, in the absence of an indemnity, the solvency of the lender of last resort may be called into question;
- the Treasury stands behind the Financial Services Compensation Scheme (FSCS). When a bank fails, the FSCS is liable to pay out to eligible depositors if the bank is put into insolvency; or to contribute an equivalent amount to the cost of the resolution if the special resolution regime (SRR) is deployed. During the 2008 financial crisis the Treasury lent around £20 billion to the FSCS. This is currently being repaid at market rates to comply with EU State Aid rules;
- the Treasury is responsible for operating the temporary public ownership (TPO) tool, the backstop option if other resolution tolls are not viable; and
- proposals for "bail-in" (write down of debt when resolution options are implemented) will reduce taxpayer exposure, and the introduction of depositor preference will reduce the FSCS liability in future resolutions. However, even given these factors the taxpayer contingent liability could still be substantial.

1.19 This exposure means that although the Bank is the resolution authority, it is acting as the Treasury's agent. The Treasury retains a key interest in the outcome of resolution (as it could have fiscal implications) and takes an active part in resolution planning. This is being formalised by the Financial Services Act 2012, which puts in place a formal requirement for the Governor to notify the Chancellor when there are public funds at risk, and gives the Chancellor a power of direction over the Bank where the Governor has made this notification.

1.20 As part of the UK, Scotland is able to maintain a large banking sector, headquartered in and operating out of Scotland. The risks that the sector poses are mitigated by the fact that there is a single framework acros the UK for addressing financial stability risks whether they arise in Scotland or elsewhere in UK.

[19] See the evidence from Stephen Boyd to the House of Lords Economic Affairs Committee, available at www.parliament.uk/business/committees

Box 1B: UK and international approaches to solving the "too big to fail" problem

One of the drivers of links between the sovereign and the financial sector – though by no means the only one – is the perception that very large firms can be "too big to fail"; i.e. that their failure would pose such serious risks to the wider economy that governments cannot afford to let them fail. A range of reforms is being implemented to ensure that the UK can maintain a successful global financial centre without asking taxpayers to bear unacceptable risks. The financial sector understands the necessity of this work. As the chair of the RBS board told the Lords Economic Affairs Committee, "Our drive at RBS in the past three or four years—and indeed the whole drive of international regulation, particularly in the UK, because of the scale of our financial crisis—has been to break that link between the sovereign and the bank."[1]

The UK's new regulatory framework, introduced by the Financial Services Act 2012, is expressly geared towards ensuring that banks can be resolved without risk. This includes the new Prudential Regulation Authority (PRA) whose objective includes a specific statement that it is not required to prevent banks from failing.

The PRA is situated within the Bank of England group. This will ensure that there is effective coordination between the prudential regulator (which determines whether firms are able to continue operating safely) and the Bank of England, which is responsible for resolving banks and building societies that fail. The Bank is also being given new powers to resolve non-bank financial institutions.

There are also extensive reforms to make firms easier to resolve without risk to the taxpayer, building on the existing requirements for recovery and resolution plans (RRPs), under which banks must lay detailed plans to address the situation that got them into financial difficulties. The key measures, contained in the Government's Banking Reform Bill, are:

- the imposition of a ring-fence, separating investment banking and related activities from more traditional personal and business lending. This is vital to reduce structural complexity and to make banks easier to resolve in crisis, where speed of execution is vital. Ring-fenced banks must be genuinely independent from other parts of the group;
- requiring banks to hold sufficient capital to absorb losses, in order to be more resilient and resolvable. Building on the international consensus for higher levels of bank capital, banks providing vital services to the UK economy must hold extra equity to withstand shocks. The UK's globally systemic and ring-fenced banks will also need to hold more loss-absorbing debt; and
- introducing a credible and effective bail-in tool through a European resolution framework, to ensure losses fall on those most able to assess bank risks. These are already endorsed by the G20 and the Financial Stability Board, through a European resolution framework. FSCS-eligible depositors will be preferred, as the Independent Commission on Banking (ICB) recommended.

[1] See the evidence from Sir Phillip Hampton to the House of Lords Economic Affairs Committee available at www.parliament.uk/business/committees

The size of the banking sector relative to the state

1.21 Banking sector assets for the whole UK at present are around 492 per cent of GDP. Although this is larger than some other states, the experience of the financial crisis that began in 2008 demonstrates that even in a situation of extreme stress, the UK has the capacity to manage these risks.

1.22 The Scottish banking sector, by comparison, would be extremely large in the event of independence. It currently stands at around 1254 per cent of Scotland's GDP.

1.23 By way of comparison at the end of 2007 Icelandic banks had amassed consolidated assets equivalent to 880 per cent of Icelandic GDP. As noted by the Organisation for Economic Cooperation and Development (OECD), this created risks for the Icelandic economy: "the banks grew to be too big for the Iceland government to rescue. Banking in these circumstances became very dangerous when the global financial crisis deepened".[20] The size of the sector relative to GDP was a major contributor to the cause and impact of the financial crisis, and the ability of the national authorities to prevent the systemic effects when it hit.

1.24 In March 2013, Cyprus faced a slightly different challenge from its banking sector. Like Iceland it had a large sector, with total banking assets around 700 per cent of GDP, including assets of domestic banks equivalent to around 450 per cent of GDP. However, its problems were compounded by the fact that the domestic banking sector was highly concentrated. At the end of September 2012, the two largest banks – the Cyprus Popular Bank and Bank of Cyprus – had assets in the region of 210 per cent and 175 per cent of Cyprus's GDP respectively. These were domestic banks, closely linked in to the economy of Cyprus, meaning that the systemic effects of failure would have been severe. As in the case of Iceland, the emergence of strains in the banking sector contributed to a rapid loss of confidence and stability, which resulted in the collapse of Cyprus Popular Bank and severe fiscal consequences which are still being understood. It is worth noting that, if Scotland became independent, its banking sector would be similarly concentrated (with two large players, Bank of Scotland and Royal Bank of Scotland and a number of smaller firms), and that an independent Scotland's domestic banking sector would be likely to be significantly larger than that of Cyprus (assuming no change to firms' domicile arrangements).

1.25 There has been a significant amount of work in recent years exploring risks posed by a large financial sector. Recent experience has emphasised the risk of feedback loops between a sovereign and its banking sector.[21] As shown in Chart 1C, there are a number transmission channels. These effects are magnified where the banking sector is very large when compare to the size of the state.[22] It is clear that an independent Scotland would have a large financial sector relative to GDP, leaving it more susceptible to the negative implications of banking crises.

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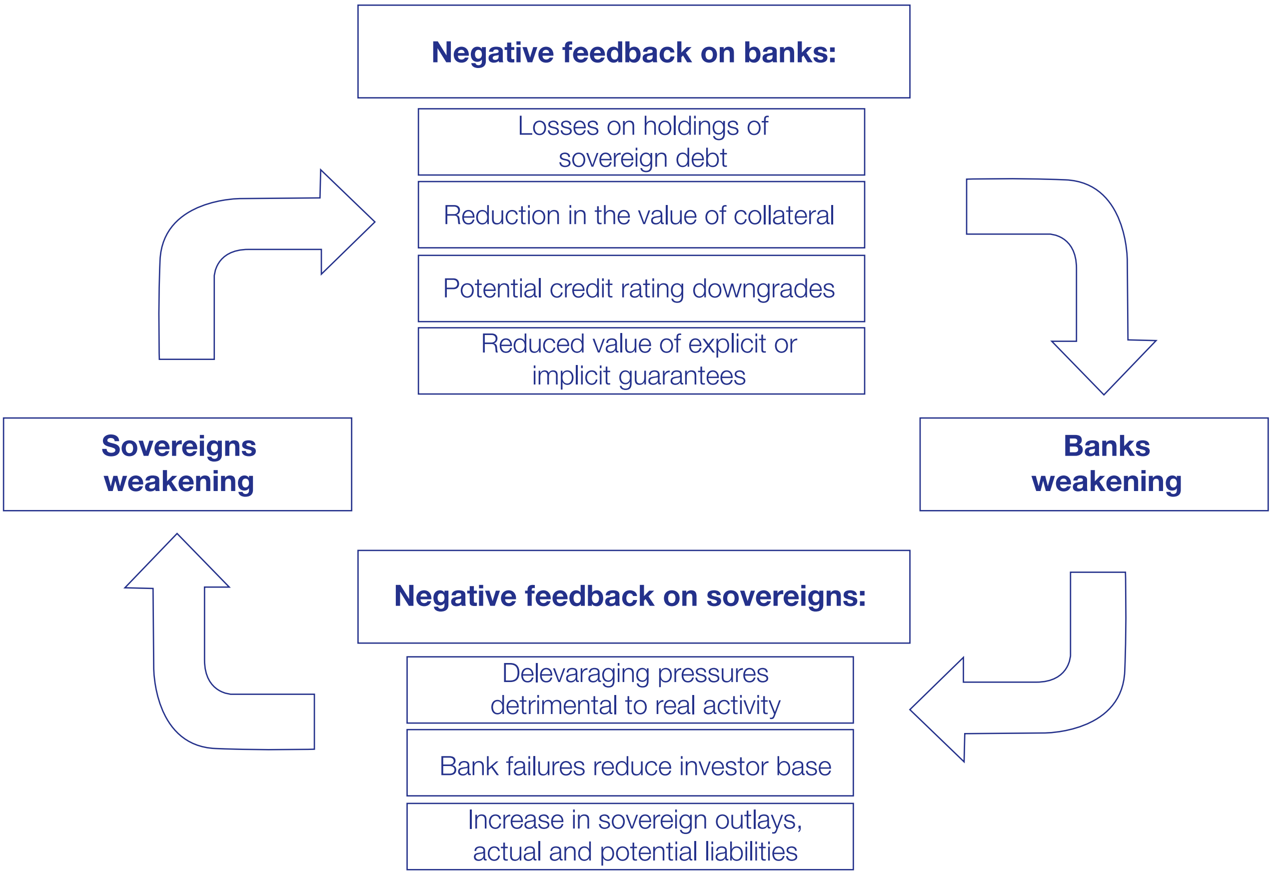
[20] *Economic Survey of Iceland 2009: The financial and economic crisis*, OECD, September 2009, page 5.

[21] See also *The impact of sovereign credit risk on bank funding conditions*, BIS, CGFS Papers No 43, July 2011.

[22] See *Cross-Cutting Themes in Economies with Large Banking Systems*, page 1, IMF, April 2010, available from www.imf.org/

Chart 1C: Adverse feedback effects between the sovereign and the banking sector



Source: *Implicit Guarantees for Bank Debt: Where Do We Stand?* OECD, 2012

Fiscal risks

1.26 Systemic banking crises have been frequent and have often carried large fiscal costs increasing public debt.[23] In the past, if large systemically important financial institutions have faced the risk of bankruptcy, governments have been forced to provide the required financial support to preserve stability. Regardless of the type of government intervention in support of the financial system, government action has translated into an increase in the explicit or implicit obligations of the sovereign with a consequent deterioration of the fiscal position. According to recent research, the median overall increase in public debt as a result of the financial crisis, which reflects both direct (i.e. costs of recapitalisation) and indirect (i.e. negative repercussions on the economy) effects of banking crises, is close to 20 per cent of GDP, although there is large variation across countries.[24] Amongst advanced economies, Iceland, Ireland, and Israel have suffered the largest fiscal costs relative to GDP. However, given the relatively large banking systems in Iceland and Ireland, fiscal costs are significantly lower in these countries when expressed relative to total financial system assets.

1.27 Financial sector vulnerabilities have become an important driver of a country's vulnerability to a fiscal crisis. The Irish sovereign debt crisis is an important recent example of how an unsound banking sector could have a negative impact on the sustainability of the public finances. Before the crisis, Ireland's banking had grown to 894 per cent of its GDP. Its

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[23] *Systemic Banking Crises Database: An Update*, Laeven and Valencia, IMF working paper 12/163, 2012. On the costs of banking crises see also OECD (2009) and the Independent Banking Commission (2011).

[24] *Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis*, IMF, 2011.

public debt grew rapidly from 25 per cent of GDP in 2007 to over 100 per cent in 2011. Around 30 percentage points of this increase was due to more than €60 billion in banking support measures provided by the Irish government, making their banking crisis the second costliest (behind Iceland's) in advanced economies since the Great Depression of the 1930s. There is also evidence that the size and the structure of the banking system are important determinants of the sovereign risk premia during periods of financial crises,[25] especially following a government bail-out. Mody and Sandri found that domestic vulnerabilities of national banking sectors are an important driver of sovereign spreads and that this is stronger for countries with high debt-to-GDP ratios.

1.28 Banking crises can lead sovereign debt crises and, in several cases, the economic effects of banking crises have lead to sovereign defaults.[26] The fiscal crisis that can result from a banking crisis emanates from a sharp economic downturn, a large increase in government expenditure, and a significant contraction in output which in turn leads to reduced government tax receipts. As debt piles up, markets perceive an increased risk the sovereign will be unable to pay its debts, pushing up the sovereign's cost of borrowing – and the vicious cycle can force default. In addition, deterioration in the balance sheets of banks can have significant negative macroeconomic repercussions if this constrains lending to the economy. If banks have not accumulated sufficient capital and liquidity buffers, credit supply can be curtailed over and above what is required given the quality of the borrower. The allocation of credit can also suffer, dampening economic activity.

1.29 Overall, the experience of financial crises shows that countries with a large banking sector compared to the size of their GDP are significantly more vulnerable. Furthermore, in September 2012, banking sector contingent liabilities for the UK were approximately 100 per cent of the whole of UK GDP (or around £30,000 per capita). If Scotland were to become independent, its contingent liabilities would be more than double those of the UK as a whole, amounting to approximately 220 per cent of Scottish GDP or £65,000 per capita. This means that faced with serious banking crisis, the possibility of bank failures would pose a very serious risk to taxpayers in an independent Scotland.

1.30 Outside of a full blown crisis, an economy's reliance on a particular sector can lead to extra volatility in that economy that generates uncertainty. Changes and tax receipts and therefore public spending are more dependent on the peaks and troughs of performance in the one sector, making planning ahead difficult.

Other smaller economies with large banking sectors

1.31 There are a number of small economies with large financial sectors – some of which came through the recent financial crisis relatively unscathed. In particular it is worth considering Luxembourg, Singapore, Hong Kong and Switzerland. Overall, it is clear that Scotland has few similarities to these economies, which were resilient to the crisis despite having a relatively large banking sector.

1.32 In a review of the experience of five economies with large financial systems (relative to GDP) during the recent financial crises – Hong Kong, Iceland, Ireland, Singapore and Switzerland – the IMF conclude that Hong Kong and Singapore developed prudent fiscal buffers and managed to escape from the crisis mostly untouched. By contrast, in Iceland and Ireland the weaknesses in the fiscal position were obscured by bubble-related revenues. Switzerland, running a significant structural surplus, managed to experience only small negative influence from the crisis.[27]

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[25] *The Eurozone Crisis: How Banks and Sovereigns Came to be Joined at the Hip*, IMF, 2011.

[26] *The Aftermath of Financial Crises*, Reinhart and Rogoff, 2009.

[27] *Cross-Cutting Themes in Economies with Large Banking Systems*, IMF, 2010.

Country	Fiscal balance, 2007 (% GDP)	Net international investment position, 2007 (% of GDP)	International reserves, 2007 (% GDP)	Banking sector assets, 2007 (% of GDP)
Iceland	5.4	-127.2	12.88	876
Ireland	0.2	-16.5	0.36	894
Switzerland	0.9	139	16.69	664
Singapore	12.4	100.5	98.65	641
Hong Kong	7.7	252	72.16	789
Luxembourg	1.2	95.5	0.40	2711.47
UK	-2.8	-22.9	2.03	415.75

Table 1B: Small economies with large financial centres, including the UK for comparative purposes – 2007 figures

Source: IMF and World Bank figures[28]

1.33 The Asian economies experienced very favourable budget balance positions in the period leading up to the recent crisis, especially in comparison with other economies that suffered more from the crisis. On average over the 2004 to 2011 period, Singapore and Hong Kong experienced a general government net borrowing surplus of 6 per cent and 3 per cent of GDP per year respectively. Building up of a large budget surplus could represent an important mitigating factor of the degree of vulnerability of a country with large banking systems to episodes of financial crisis. There is also a large body of evidence on the determinants of banking and currency crises suggesting that large budget deficits are good leading indicators of financial crises, as they are likely to reduce the government's ability to repay debt and to increase the risk of monetisation. In particular, higher fiscal deficits are likely to reduce investor's confidence in the domestic currency.

1.34 Although holding large fiscal buffers may have played an important role in mitigating the Asian economies vulnerability to the recent financial crisis, it is important to recognise that several other key factors have contributed to reduce their vulnerability, including most notably a very favourable external position with large stock of international reserves (as a share of GDP), a banking sector with a relatively well-diversified funding structure and relatively effective financial market regulation and supervision.[29]

1.35 Luxembourg has a very large financial sector when compared to the size of its economy. However there are two key factors which mean that is less exposed to financial shocks. First, Luxembourg's sector is a fundamentally different kind to that of Scotland and the rest of the UK. The overwhelming majority of its banks are foreign owned,[30] and 90 per cent of assets are foreign assets. The IMF financial stability assessment of Luxembourg notes

[28] These figures provide a good indication of the overall macroeconomic differences between these economies. But as they have been drawn from different sources, they should be treated with a degree of care. The data has been taken from *Cross-cutting Themes in Economies with Large Banking Systems*, IMF, 2010, and *Global Financial Stability Report Responding to the Financial Crisis and Measuring Systemic Risks*, IMF, April 2009, both available at www.imf.org; Eurostat (epp.eurostat.ec.europa.eu); and the World Bank (data.worldbank.org).

[29] IMF (2011) has also highlighted other factors that could make an economy (especially with a large banking sector) particularly vulnerable to episodes of crises including the presence of large cross-border dimension to its banks and issuing a (non-reserve) currency or adopting a reserve currency as its legal tender.

[30] Some estimates put the figure at 99 per cent in 2007, see *Iceland on the brink? Options for a Small, Financially Active Economy in the Current Financial Crisis Environment*, Daniel Gros, 2008, page 9 available from www.ceps.be. See also *Foreign Banks: Trends, Impact and Financial Stability,* Stijn Claessens and Neeltje van Horen, January 2012, *IMF working paper*, January 2012 available from www.imf.org/

that: "most banks and 90 per cent of total bank assets are foreign-owned. The majority of these groups operate through both subsidiaries and branches in Luxembourg, which provides flexibility to accommodate clients' needs for financial services and to optimize funding operations with parent groups". It notes that "the local banking system is a net provider of liquidity to parent banks" and that "interbank positions represent about half of bank assets and liabilities (compared to an average of about 28 per cent in the euro area), two thirds of these interbank positions are cross-border exposures, and intra-group exposures account for about 40 per cent of total bank assets."[31]

1.36 In other words, Luxembourg's financial sector superficially appears to be very large, because of the role that its banks play as offshore providers of liquidity to other entities within their own banking groups. Luxembourg is therefore far less exposed to its financial system than simple "assets to GDP" ratio would seem to imply. For Scotland to have a similar kind of banking sector to Luxembourg would effectively require it to develop an entirely new kind of industry (based on the provision of liquidity to foreign banking groups) rather than build on the traditional strengths of the Scottish sector, for example in retail banking.

1.37 Finally, Luxembourg had very strong macroeconomic fundamentals, including an exceedingly large net international investment position, as can be seen from Table 1B. For Scotland to achieve a position of such economic strength that it could sustain a sector of around 1250 per cent of its GDP (significantly larger than Iceland immediately prior to the crisis) would require it to run large budget and current account surpluses, which is likely to be extremely challenging for a new economy starting out in an uncertain economic environment.

Alternative approaches to managing risk

1.38 A number of proposals have been put forward as to how Scotland could manage these financial risks should it become independent. The Scottish Government has, for example, suggested continuing to use the Bank of England as its central bank and lender of last resort. The Scottish Government's Fiscal Commission Working Group has proposed a model in which prudential regulation would be carried out "on a consistent basis across the sterling zone".[32] Charles Goodhart has argued that "One potential solution for Scotland and the redefined UK would be to have the type of framework that the EU authorities are hoping to achieve at some future date in Europe: that is, a banking union, one supervisory body (with potential for some regional variation in application), a common deposit guarantee scheme and a formal process for solving cross-border resolution issues."[33]

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[31] *Luxembourg: Financial System Stability Assessment – Update*, IMF, June 2011, page 8, available from www.imf.org/

[32] *Fiscal Commission Working Group, First Report – Macroeconomic Framework*, The Scottish Government, February 2013, page 9 available from www.scotland.gov.uk

[33] *Scottish financial structure*, Charles Goodhart in Andrew Goudie (ed.) *Scotland's Future – The economics of constitutional change*, 2013, page 148.

1.39 Part of the purpose of these proposals seems to be an attempt to recreate the benefits of the current constitutional setup, in which Scotland maintains a large and prestigious financial sector while sharing the risks with the rest of the UK. However, any such arrangements would be significantly more complex than those that currently exist, and would not effectively recreate the existing advantageous position. Notably the case for fiscal support across international boundaries to another state would be far less clear, and would be crucially dependent on one state's taxpayers being willing to support another's.

1.40 Under the existing constitutional setup, there are clear responsibilities in a crisis. Of particular importance is the role of the Chancellor, who has powers under UK law to intervene on all resolution decisions that have the potential to impact on public funds. This is particularly important because, as discussed throughout this chapter, large banking failures can have severe fiscal consequences. The Chancellor's accountability to the UK general public for the decisions that are made in a crisis is therefore of paramount importance. As discussed above, this is given explicit recognition in the Financial Services Act 2012, which came into force on 1 April 2013.

1.41 If responsibility for regulation and resolution were to be "shared" in the way that it is implied in proposals above, it would weaken the UK authorities' control over macro prudential supervision and dilute the UK Government's responsibility for fiscal decisions about bank failures and resolution. These proposals would also not give the government of an independent Scotland the levers it needed, particularly as the smaller partner in the partnership. Overall, these alternative approaches to managing financial risk are likely to be unappealing to both parties in the longer term, even if in practice they are deliverable, which is uncertain given the significant additional complexity they would entail.

1.42 As discussed in *Scotland analysis: Currency and monetary policy*,[34] strong international integration of financial markets has resulted in a number of traditional lender of last resort (LOLR) operations having cross-border effects. In particular, large operations aiming at the provision of general liquidity to the financial system were often extended to financial institutions registered abroad. For example, during the recent financial crisis, non US-registered banks were able to access emergency loans from the US Federal Reserve and non euro area registered banks were able to access the ECB's long-term refinancing operations.

1.43 However, the financial crisis has shown that such international cooperation is typically limited to liquidity based interventions. When questions are raised about the solvency of domestically-domiciled financial institutions, it is national governments that can be required to commit public funds to these institutions in order to stabilise the wider financial system.

1.44 Alistair Darling, on his experience of the recapitalisation of RBS as the Chancellor of the Exchequer,[35] said: "All I can tell you is that, on the night of 7 [October] 2008, no one at all anywhere in the world rushed to chip in to bail out RBS, despite the fact that it had a very large trading arm in the United States and many of the losses that it made were there. Obviously the US Fed was immensely helpful in terms of liquidity support and tiding over; it kept RBS going for a whole afternoon when it got into trouble on that Tuesday. When it came to recapitalisation, though—I think that the recapitalisation figure is about 30 per cent of Scottish GDP—there was no one queuing up to do it. As Mervyn King said, these banks are global in life but national in death."

[34] See *Scotland analysis: Currency and monetary policy*, HM Government, April 2013, available at www.gov.uk/scotlandanalysis

[35] See evidence to the House of Lords Economic Affairs Committee, available at www.parliament.uk/business/committees

Box 1C: Could Scotland mitigate these risks by joining a banking union if it became independent?

If Scotland achieved membership of the EU, it would be required to join the euro, unless it was able to negotiate an opt-out (euro membership is a requirement for all new members of the EU, and only Denmark and the UK have successfully negotiated opt-outs).[1]

Euro membership would mean that Scotland's deposit-taking banks would come under European Central Bank (ECB) supervision as part of the Banking Union proposals (the most significant banks would fall under direct ECB supervision, the other banks would be regulated at national level albeit within the framework established by the ECB and subject to potential direct oversight of the ECB). Banking Union is an aspect of the inexorable logic of the single currency, and is part of the process towards the achievement of a genuine Economic and Monetary Union. It seeks to cut the link between stressed euro Member States and their banks, including through the creation of a Single Resolution Mechanism with a common authority responsible for the resolution of banks within the Member States participating in the Banking Union and a centralised pool of funding to support the Mechanism.

If the cost of resolving euro-area banks is transferred to the euro area level, the supervision of those banks must necessarily also be transferred to the euro area level. The Banking Union therefore has three pillars:

- the Euro-area Supervisory Mechanism – this will give the ECB direct supervision of banks and banking groups in euro area countries and any other countries which choose to participate;
- the Euro-area Resolution Mechanism – this will permit the managing down of non-viable banks in such a way as to protect taxpayers and minimise the impact on markets and the wider economy; and
- the Euro-area Depositor Guarantee Scheme – this will provide the compensation safety net to consumers in the event that a bank fails.

An independent Scotland might be able to choose to participate in the Banking Union prior to entering the euro if it wished (or in the event that it managed to negotiate an opt-out from the euro). However there would be a number of drawbacks to this approach:

- it would mean that the regulation of prudential risk would not be carried out on equivalent basis across an independent Scotland and the continuing UK. This is contrary to the approach proposed so far by the current Scottish Government. If an independent Scotland were to maintain a currency union with the UK by some mechanism, this would result in there being two prudential regulatory regimes over a single currency area, which is exactly the outcome which banking union is intended to avoid;
- if an independent Scotland negotiated an opt-out from the euro, it would not be a member of the ECB's key decision-making body the Governing Council of the ECB. ECB supervision would be focused on the safety and soundness of the banks operating in Scotland. Issues such as availability of credit to Scottish homes and businesses, purchase of Scottish national debt, the role of banks as transmitters of Scottish monetary policy would not fall within its remit, but in the absence of supervisory oversight it is not clear what influence Scotland would have on these important issues; and
- joining Banking Union would equate to a loss of control, in terms of both macro prudential supervision and for the responsibility over taking key decisions about bank failures and resolution. Decisions about whether a failing bank should be rescued and what losses non-insured creditors should bear would be taken at the euro area level.

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1 Currency options are discussed in more detail in *Scotland analysis: currency and monetary policy*, HM Government, 23 April 2013, available at www.gov.uk/scotlandanalysis

The advantages for Scottish firms as part of the UK

1.45 As discussed earlier in this chapter, the current constitutional setup supports firms based in Scotland. They retain the distinct advantages of being headquartered in (and operating out of) Scotland. However, they also benefit from the wider stability and market confidence that comes from being based in a larger state. Being in a smaller sovereign would likely create difficulties for the sector, particularly for large firms. This section discusses how market perceptions of the "riskiness" of firms is linked to the perceptions of the sovereign in which it is based, and the implications for their funding costs.

Credibility in financial markets

1.46 As a number of independent commentators have argued,[36] if Scotland became independent it would not have the UK's track record with the international financial markets, and could therefore be perceived by financial markets as less credible. When markets perceive weaknesses in the credibility of the sovereign, this negatively impacts the credibility of domestic banks, with a consequent increase in the cost of funding. Market perceptions of banks' solvency are more closely linked to perceptions of the sovereign during periods of stress, particularly for those countries that experience a significant deterioration in their sovereign credit risk.[37]

1.47 This is because where there is an increase in market perception of the risk that a sovereign will default on debt repayments, this increases banks' credit risk.[38] For example, Acharya *et al* (2011) assessed empirically the strength of the relationship between sovereign and bank credit risk in a set of European economies for the period from November 2008 to December 2010 using daily data. After controlling for the banks' credit quality, they found that the relationship between bank and sovereign CDS[39] is positive for all banks and statistically significant for banks with lower ratings (i.e. A or BBB). For example, a 10 per cent increase in the sovereign credit default swap (CDS) leads to an increase in the bank CDS of 1.2 per cent for banks with a credit rating of AA or above. However, the impact for banks of lower credit quality (i.e. A or BBB rating) is significantly higher. A 10 per cent increase in the sovereign CDS translates into a 3.1 per cent and 2.6 per cent increase in the bank CDS.

1.48 The tight relationship between the sovereign and bank's credit risk is illustrated in Chart 1D, which shows a positive correlation between banks and sovereign CDS (Angeloni and Wolff, 2012). The authors also note that this relationship persists even where the bank divests itself of holdings of its home state's debt – observing that "the financial market seems to incorporate the country risk associated with the location of the individual banks." This indicates that it is possible that, even if banks in an independent Scottish state do not exhibit the usual "home bias" in their holdings of sovereign debt (i.e. they instead have large holdings of other sovereign debt), they are still likely to be the subject of negative market perceptions, for example through the channels identified above.

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36 See the evidence to the House of Lords Economic Affairs Committee available at www.parliament.uk/business/committees

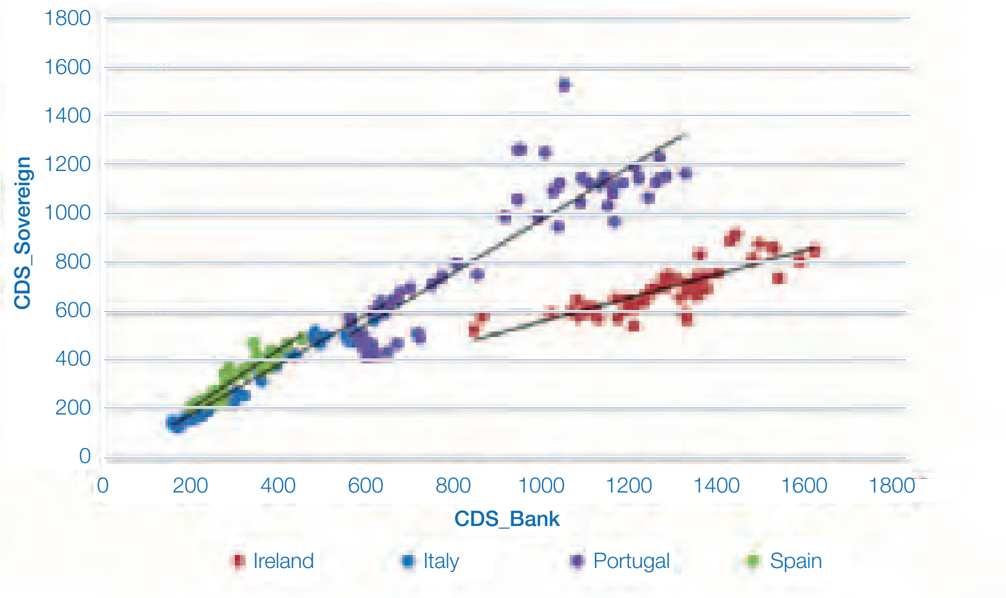
37 A sovereign downgrade of a main European Investment Bank (EIB) sovereign shareholder could also have potential negative implications for the EIB AAA rating. This will clearly depends on which country is downgraded. A downgrade of one or more AAA shareholders could put significant pressure on the EIB's AAA rating.

38 Also Dieckmann and Plank (2010) found a positive relationship between banks and sovereign CDS after rescue packages are in place but a negative correlation while rescue packages are being put in place.

39 A credit default swap (CDS) is an agreement under which the seller of the CDS will compensate the buyer if a 'credit event' occurs, for example if the subject of the CDS defaults on a loan.

1.49 As the chair of the RBS board told the House of Lords Economic Affairs Committee, "domicile can be important to providers of funds."[40] There are two key reasons for this. First, credit rating agencies consider the overall economic and financial strength of the environment in which the bank is based when assessing banks' financial strength. Second, when considering the riskiness of lending, regulators take into account the lender's exposure to the whole jurisdiction into which they are lending. Credit risk (i.e. the risk that loans may not be returned) is generally assessed as being higher for large exposures to small economies

Chart 1D: Correlation between sovereign and bank CDS



Source: *Angeloni and Wolff (2012)*[41]

1.50 This means that the size of the economy in which a bank is based effectively puts a ceiling on the amount which a bank can borrow cheaply. For this reason, perceptions of sovereign risk feed directly into the rates at which banks can borrow – which in turn is passed on to consumers, for example in an increased cost of mortgage lending (see also Chapter 3). A key risk of independence is that the Scottish banking sector would likely be perceived as more vulnerable, resulting in higher funding costs which are then passed on to consumers.

1.51 Being based in a less "safe" jurisdiction is also likely to mean that banks would be required to hold more capital. Internationally, there are significant differences in prudential standards, taking into account the local environment. Directives on bank capital give regulators discretion to impose additional capital requirements on firms in order to mitigate risks to financial stability.[42] Brian Quinn, a former executive director at the Bank of England, argues: "If an independent Scottish Government had or developed economic or social policies with priorities which differed significantly from those of a rUK ['residual UK' – i.e. the UK that would remain after Scotland had left] government, difficulties could arise. The

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[40] See the evidence from Sir Phillip Hampton to the House of Lords Economic Affairs Committee available at www.parliament.uk/business/committees

[41] *Are banks affected by their holdings of government debt?*, Chiara Angeloni & Guntram B. Wolff, 26 March 2012, available at www.bruegel.org

[42] The Capital Requirements Directive IV (CRD 4) will allow national supervisors in individual Member States to impose additional capital requirements where necessary, under what is referred to as "Pillar 2".

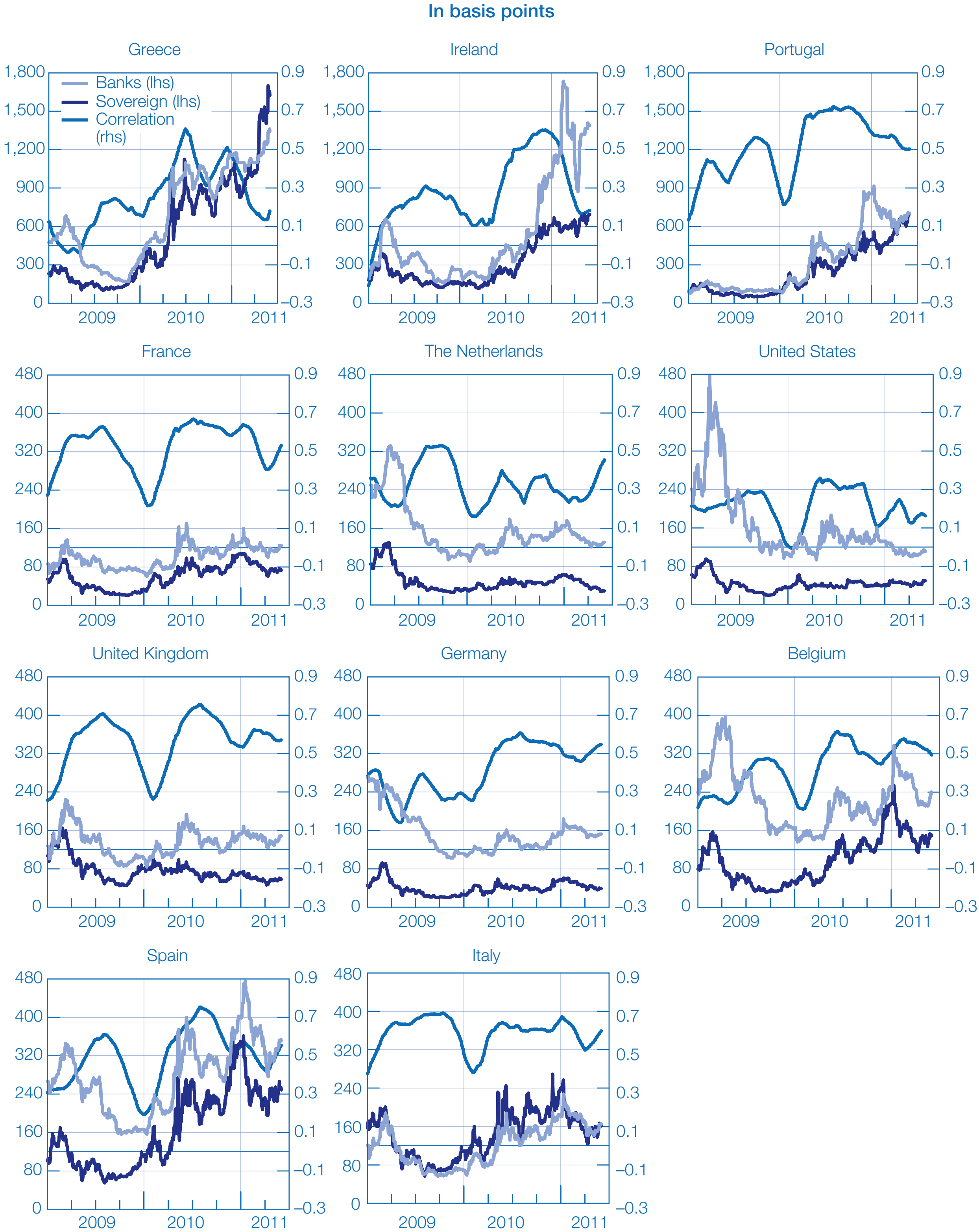
Prudential Regulation Authority (PRA) could judge that Scottish incorporated institutions were, as a result, operating in a riskier environment and could decide that higher capital adequacy or liquidity requirements were justified, greater provisions for loss were needed, and/or higher risk weights for certain classes of bank loans were appropriate."[43] Requirements to hold additional capital would significantly increase banks' costs of doing business, and consequently the costs for businesses and households.

Impact on funding costs

1.52 In general, wholesale funding costs for firms are linked to the market perceptions of the financial strength of the sovereign and the risk that it will default on its debts. This impact can be seen in CDS premia spreads. Chart 1E shows a range of CDS Spreads for a number of sovereigns and their respective banks, showing a clear link between bank costs and changes to market perceptions of the sovereign's credibility and financial strength.

[43] *Scottish Independence: Issues and Questions*, Brian Quinn, David Hume Institute, 19 November 2012, page 8, available at www.davidhumeinstitute.com

Chart 1E: Sovereign credit risk premia in selected advanced countries[44]



Premia on five-year CDS on senior bonds issued by sovereigns or banks. The correlation index is equal to the three-month moving average of the correlation between changes in the two time series of CDS spreads, calculated on the basis of a GARCH (1,1) statistical model, using daily data.

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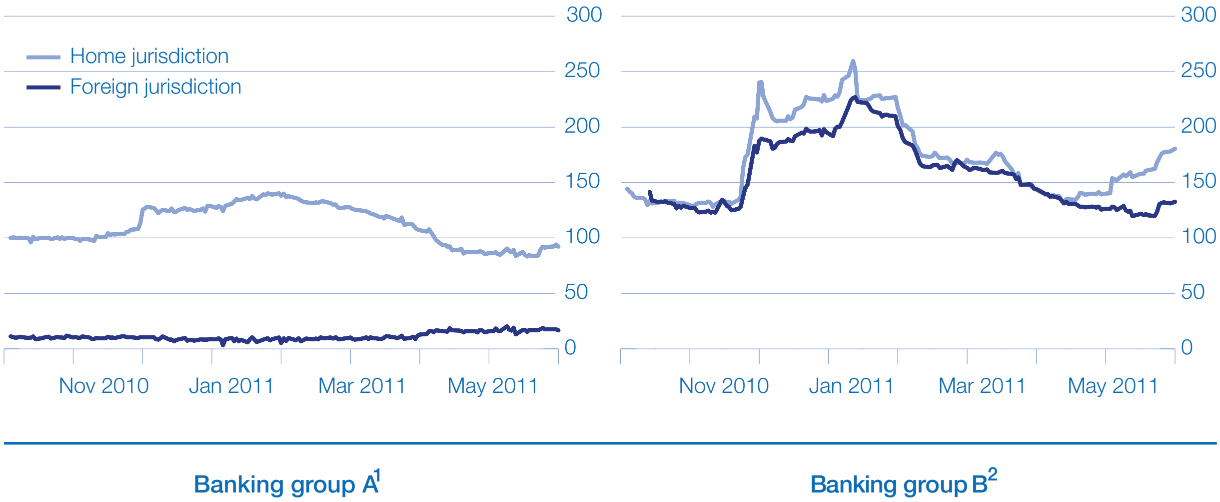
44 *The impact of sovereign credit risk on bank funding conditions*, BIS, July 2011.

1.53 Subsidiaries of firms based in higher rated sovereigns are, in the main, rated higher than their parent bank and have lower funding costs. This is shown in Chart 1F, taken from a paper from the Bank for International Settlements.

Chart 1F: Bond spreads in different jurisdictions



Daily data, in basis points

Source: *The impact of sovereign credit risk on bank funding conditions*, BIS, July 2011

1.54 This evidence also suggests that, despite the benefits that subsidiaries receive from being domiciled in a lower risk sovereign, they are still negatively affected through association with a parent being based in a higher risk state. For example Santander UK, which is a UK subsidiary with exposure limited to the UK and strongly ring-fenced from the Santander Group based in Spain, is still affected by their link to, and therefore risk associated with, their parent company. This is seen in the CDS premia, in which Santander UK has the highest costs of any UK bank, despite having the same credit rating as Lloyds and RBS.

Box 1D: Cost of mortgage funding

Broadly speaking, funding for mortgages is raised through a combination of retail deposits and wholesale funding. There are a number of reasons why it is advantageous for a mortgage lender to fund itself using deposits. First, deposits can be a relatively cheap form of funding. Second, they are less likely to result in mismatch between assets and liabilities. However, funding through deposits is difficult to raise in the short term and can be insensitive to changes in the interest rates, meaning that most lenders have to use other forms of funding.

The precise impact of an independent Scottish state on the cost of deposit funding is difficult to calculate with any certainty as it depends on the actions and decisions taken by consumers in choosing their bank. First, in the long term, Scottish lenders may lose retail market share if customers from the rest of the UK move to bank with locally based institutions. There are a number of reasons why this might happen. For example, as discussed elsewhere in this paper (see Chapter 3), there is a question over whether a Scottish deposit guarantee scheme could be sufficiently well-funded to ensure that it could meet claims against it in the event of the failure of a large deposit taker (because the market would be highly concentrated). This could lead to a wider loss of depositor confidence in Scottish authorised institutions. This could mean that Scottish firms had fewer deposits and therefore less funding to provide competitive mortgages, both in terms of value and volume. The price of retail funding would increase in this scenario as deposit takers would have to offer higher rates of interest to attract depositors.

Mortgages can also be funded through wholesale funding, largely through securitisation and covered bonds. Securitisation takes an asset or pool of assets and uses these to raise funds from bond markets. In its simplest form, it involves the sale of an asset to a special purpose vehicle (SPV) or trust, which then issues notes or bonds backed by the assets to investors. Covered bonds are similar to a standard unsecured bond, except a pool of assets (usually mortgages) is put aside to provide extra security for investors. Both securitisation and covered bond issuance may be a more expensive way of raising funding for Scottish banks if Scotland were to become independent. This is because at present UK mortgage securitisations benefit from the reputational reassurance of being issued by a UK institution – the UK residential mortgage backed securitisation market is long-established and highly liquid, which keeps funding costs down for issuers.

The cost of issuing a covered bond is linked closely to both the rating of the issuing bank (which as evidence suggests would be lower for Scottish banks under independence) and also the regulatory environment (as covered bonds issuers are governed by prescriptive requirements set out by the regulatory authority). It is therefore likely that this form of funding would be more expensive under independence.

Increased costs of mortgage funding are highly likely to translate into increased costs of mortgage borrowing for consumers. This is discussed in more detail in Box 4G in Chapter 4, which consider the wider impact on consumers should Scotland become independent.

Reactions to heightened risk in an independent Scotland

1.55 As discussed in this chapter, if Scotland became independent, and assuming that the Scottish financial services sector remains structured as it is, Scotland would have a very large banking sector relative to the size of its economy. Scotland's banking sector assets would be over 12 times its GDP.

1.56 As further discussed in this chapter, if Scotland became independent it could cause significant difficulties for financial services firms, particular around their cost of borrowing. There is a substantial area of uncertainty around the reaction of large firms to these risks. These would be difficult decisions for industry, particularly those firms that have strong historic and cultural links to Scotland. The chair of RBS has said publicly: "If, as a result of a vote for independence, we found extra difficulties, cost pressures or whatever, we would have to think about alternatives."[45]

1.57 As the analysis in this chapter makes clear, there would likely be significant incentives for large firms to make changes to their group structure in order to address the funding and financial stability risks arising from independence, most importantly moving their domicile from an independent Scottish state to the continuing UK, or to another jurisdiction. Commentator such as Charles Goodhart have suggested that such an outcome is likely.[46] In this event, there are a number of possibilities for the continuing provision of banking services in an independent Scotland. For example, retail banking could be provided through branches of banks based elsewhere, following the example of New Zealand in which the sector is dominated by banking groups based in Australia.[47]

1.58 Any development which involved firms leaving an independent Scotland would affect Scotland's reputation as an important financial centre. As discussed in Chapter 2, the movement of one or more large firms out of the Scottish financial services "cluster" would also be likely to have a negative impact on the overall attractiveness of Scotland as a place for financial services to be based.

1.59 The Scottish financial services industry has developed in the context of a single fiscal area across the UK, and there would be negative effects if, as a result of constitutional change, that were no longer the case. The implication is that either the size of the sector would reduce (with negative effects on employment, GDP, and the provision of banking services), or that firms, taxpayers and consumers would be required to absorb the costs associated with heightened risks to financial stability.

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[45] See the evidence from Sir Phillip Hampton to the House of Lords Economic Affairs Committee available at www.parliament.uk/business/committees

[46] See *Scottish financial structure*, Charles Goodhart in Andrew Goudie (ed) *Scotland's Future – the economics of constitutional change*, 2013.

[47] *New Zealand: 2012 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice*, IMF, June 2012 available at www.imf.org

Chapter 2: A competitive Scotland

Scotland has a strong and competitive financial sector, with a distinct Scottish identity and significant advantages in terms of skills and location. These strengths are widely recognised and have led to major financial institutions establishing a presence in Scotland, with strong links to the rest of the UK.

The UK Government took the decision to locate the headquarters of the UK Green Investment Bank (UK GIB) in Edinburgh because of the city's long-established expertise in key areas of financial services such as asset management, as well as its thriving green sector. The UK GIB also benefits from a transaction team in London with first-class links to the City, allowing the institution to harness strengths across the UK. These beneficial links between the Scottish financial services sector and the City of London are important to many other financial institutions that have chosen to site themselves in Scotland.

In addition to these advantages, Glasgow and Edinburgh benefit from being in the same regulatory jurisdiction as London, the largest financial centre in Europe, and part of the wider UK regulatory environment. This brings a number of advantages:

- **the UK is seen internationally as having a strong tax and regulatory environment**, which engenders trust among customers and counterparties of UK business;
- **the UK environment minimises costs to firms.** If Scotland became independent, it would be likely to increase the cost of funding for firms based in Scotland, and would increase the operational costs for firms who wished to carry on business in an independent Scottish state and the continuing UK; and
- **being part of the UK helps support the Scottish financial services cluster.** The tax, regulatory and cost factors noted above help to sustain the Scottish financial services cluster, including the professional services supporting the sector. To the extent that Scottish independence reduced these advantages, it would hamper the ability of firms to recruit and retain skilled and mobile staff (thereby adding to the challenges facing the sector and putting further pressure on staffing and costs).

Remaining within the UK offers significant advantages for Scottish firms allowing them to be both distinctly Scottish and part of the UK. In particular, the UK offers an established international platform to take advantage of the rapid growth of the Asian economies. Equally, the UK benefits from a skilled and competitive Scottish industry. Separation would damage that competitive environment.

2.1 Scotland has a highly successful financial services sector, which is crucial to the wider Scottish economy through its contribution to GDP and jobs. Scotland has many significant advantages as a place for doing business. For example, the large number of high quality graduates from Scottish universities has helped attract firms.

2.2 These strengths are widely recognised and have led to major financial institutions establishing a presence in Scotland, with strong links to the rest of the UK. The UK Government took the decision to locate the headquarters of the UK Green Investment Bank (UK GIB) in Edinburgh because of the city's long-established expertise in key areas of financial services such as asset management, as well as its thriving green sector. The UK GIB also benefits from a transaction team in London with first-class links to the City, allowing the institution to harness strengths across the UK. These beneficial links between the Scottish financial services sector and the City of London are important to many other financial institutions that have chosen to site themselves in Scotland.

2.3 As shown below, among global financial centres only London and New York benefit from the full range of strong supporting industries, such as law, accountancy and IT services, which are a vital component of the clustering effect (as explained in Box 2C). As part of the UK, the Scottish financial services sector benefits enormously from having close ties to the City of London.

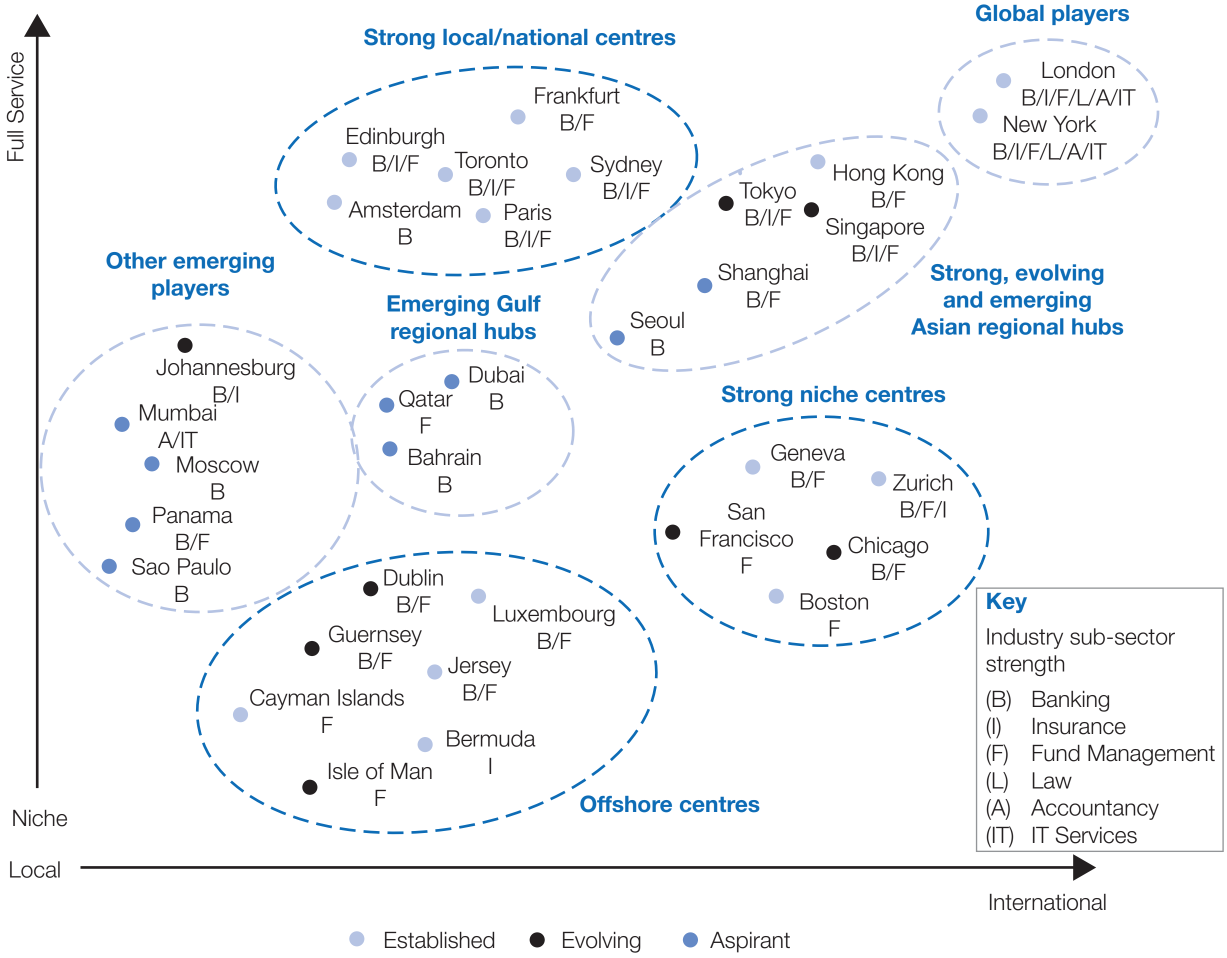
2.4 Equally, London benefits from the fact that it is in the same state as the large Scottish firms, which add to its scale and critical mass, enhancing the UK sector's size and prestige on the global stage. An industry report to the previous UK Government in 2009 was clear that "the values underpinning London's current reputation are founded on a national, rather than a single-city, embrace of the country's global trading heritage. London's position as the main entry point for international financial services is supported by the industry's relationship with the wider UK economy."[1] As Chart 2A shows, London and Edinburgh are both considered important financial centres, sharing in the benefits of the being part of a strong UK. Glasgow, too, in recent years has developed a strong reputation as a financial centre. In the 2013 Global Financial Centres Index it overtook Edinburgh for the first time.

2.5 As shown in Chart 2A, Edinburgh is a strong local centre. However, should Scotland become independent, it could result in significant changes to the local environment. This section discusses three broad areas where the existing constitutional set up brings advantages to firms on both side of the border:

- the well-established and credible regulatory framework;
- the advantages in terms of cost of doing business; and
- the strong links to the rest of the UK which help to support and sustain the Scottish financial services cluster.

[1] *UK international financial services – the future A report from UK based financial services leaders to the Government*, May 2009, page 30, available at webarchive.nationalarchives.gov.uk

Chart 2A: International financial centres



Source: Citi, Oliver Wyman – cited in the Bischoff report[2]

2.6 As discussed throughout this section, these are very real benefits to the whole of the UK. These factors would be likely to be negatively affected by independence, weakening the Scottish financial services cluster.

UK regulation

2.7 There are clear benefits from being part of the UK regulatory regime that brings certainty and credibility to doing business across all of the UK and globally. Regardless of whether Scotland chose to replicate UK financial regulation if it became independent, Scotland would require a separate regulator accountable to the Scottish Government. Decisions about how to regulate key industries are core decisions for an independent state. This is particularly the case with the financial services industry, because the performance of the sector is closely linked to wider economic and fiscal performance: both through its role in supplying credit to households and businesses, and because of the severe effects on the economy that can result if regulation fails (as discussed in Chapter 1). There are some minimum standards that Scotland would be likely to wish to put in place should it become independent, either because it would be required to do so (by EU law if it became an EU Member State), or to ensure consistency with international standards. These are summarised in Annex B.

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2 *UK international financial services – the future A report from UK based financial services leaders to the Government*, May 2009, available at webarchive.nationalarchives.gov.uk

Box 2A: What scope is there for "shared institutions" to manage financial risk in the event that Scotland becomes independent?

A number of models have been suggested for an independent Scotland's financial regulation, including most recently a proposal from the Scottish Government's Fiscal Commission Working Group that prudential regulation would be carried out "on a consistent basis across the sterling zone" which they propose (i.e. across the continuing UK and an independent Scotland), whereas conduct regulation would be subject to a different set of standards imposed by Scottish authorities. This analysis does not consider those proposals in detail; however it is worth considering some of the difficulties they would entail.

First, there are problems of accountability. An independent Scotland would be a separate state. The UK regime has UK wide jurisdiction and is accountable to the UK Government. The UK financial services regulators are established under UK law, principally the Financial Services and Markets Act 2000 as amended by the Financial Services Act 2012, although there is a range of other legislation covering mutuals, pension providers and others. Under this legal framework, the regulators are accountable to the UK Government and Parliament. Key positions are appointed by the Crown on the advice of the Prime Minister (for example the Deputy Governor for Prudential Regulation of the Bank of England, who is Chief Executive of the Prudential Regulation Authority) or by the Chancellor (for example Chief Executive of the Financial Conduct Authority). Where there is regulatory failure, the regulator must carry out an investigation and provide a report to the UK Treasury to be laid before the UK Parliament.

Second, even if the UK's prudential regime were to be adopted wholesale by any independent Scottish Government on "day one" after independence (as discussed in Annex B) it would lack the credibility of a regulatory framework that has been built over a significant period of time. As discussed elsewhere in this chapter, the UK regulatory framework is viewed internationally as robust and credible. Combined with the fact that, as discussed in the previous chapter, the Scottish sovereign would have no proven track record (or credit history), this is likely to make international counterparties more cautious when dealing with Scottish firms. In a highly competitive international environment, this would likely be a disadvantage to firms that have an international focus, such as asset management – to date a traditional strength for Scotland.

Overall, even if the continuing UK consented to "share" its regulators with an independent Scotland (and this would be a matter for future Governments of the UK to determine), it would be difficult to deliver prudential policy on a consistent basis UK-wide because, as discussed in Chapter 1, with two separate fiscal policies, the macroeconomic environment in the continuing UK and Scotland would be more complex. Moreover, it seems unlikely that the UK would wish to share sovereignty over its prudential regulator. Overall, it would be difficult for an independent Scotland to create and maintain the highly advantageous regulatory environment it currently enjoys as part of the UK, and which is discussed in more detail below.

Finally, one of the advantages of having consistent regulation across the UK is that it enables firms to operate in all areas without being subject to differing regulatory standards. It also ensures that there are consistent standards of consumer protection no matter where customers and firms are based. As discussed in this chapter, having different standards of conduct regulation would undo this benefit – creating additional operating burdens for firms and complexity for customers.

Advantages of the existing framework

2.8 The UK is currently implement wide-ranging reforms to strengthen the regulation of the financial sector, including through establishing of new, more focused regulators and the ringfencing of banks' retail operations from riskier investment banking.[3]

2.9 Despite the challenges since 2008, the UK is still seen internationally as having a strong tax and regulatory environment, which engenders trust among customers and counterparties of UK business. The OECD notes that "The vigour and breadth of the United Kingdom's Better Regulation policies are impressive, which makes it well placed to address complex regulatory challenges such as climate change and the regulatory management issues flowing from the financial crisis."[4] Michael Mainelli notes that "London and New York are in the top quartile of over 80 per cent of the instrumental factors used to build the GFCI (the Global Financial Centres Index). London appears to be particularly strong on regulation and the quality of its people."[5]

2.10 UK investors are also able to benefit from the largest network of double tax treaties in the world, covering over 100 countries. The UK is an internationally respected centre of asset management and provides a well-understood approach to the taxation of funds and their investors. The UK is a natural choice for fund management and domicile.[6]

2.11 The Global Financial Centres Index (GFCI) places regulation second on its list of key elements of successful financial centres.[7] London is rated as the most competitive international financial centre, scoring the highest on almost every element of the index. The GFCI notes that "The top four financial centres in GFCI 12 – London, New York, Hong Kong and Singapore – also share the top four places in each of these sub indices (as they have in the past four editions of GFCI). This confirms their strength in all five areas of competitiveness. It also confirms our belief that a genuinely top global centre is competitive in all areas – successful people like to live and work in successful centres."[8]

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3 See www.gov.uk/government/topics/financial-services

4 *Better Regulation in Europe: United Kingdom*, OECD, 2010, page 14.

5 *What Makes a Successful Financial Centre?* Speech by Michael Mainelli, October 2009, page 10.

6 The network of double taxation arrangements will be discussed in more detail in later work published as part of the Scotland analysis programme.

7 The five factors are: "People" – the availability of good personnel and the flexibility of the labour markets; "Business Environment" – regulation, tax rates, levels of corruption and ease of doing business; "Market Access" – levels of trading, as well as clustering effects from having many financial services firms together in one centre; "Infrastructure" – the cost and availability of property and transport links; "General Competitiveness" – the concept that the whole is 'greater than the sum of the parts'.

8 *The Global Financial Centres Index*, Z/Yen, September 2012, page 33. available at www.zyen.com

Box 2B: Example – benefits of a credible sovereign and regulator to the asset management industry

The importance of the regulator is highlighted in the recent Investment Management Association (IMA) survey of asset managers.[1] "We asked interviewees to what degree good regulation was still seen as a reason to be located operationally in the UK. There was little talk of relocation and it was noted that some hedge fund operations had recently come back to the UK." Confidence in the regulator can also be an important driver of client and investor confidence – as the IMA survey goes on to say, "For some, the answer to the question was quite straightforward; they could not leave. Many clients want and expect their manager to be in the UK." As context, around a third of asset management business in Scotland is with non-UK clients.

As discussed in Chapter 1, the banking sector is closely linked to the credibility of the sovereign, with changes in perception of the sovereign's creditworthiness explicitly linked to funding costs. This relationship is not as pronounced with asset managers, who are essentially managing a portfolio of assets on behalf of a client, and do not necessarily have the same exposure to the creditworthiness of the state. However, there are significant reputational benefits of being based in the UK and within the UK regulatory system.

1 *Asset Management in the UK 2011-2012*, Investment Management Association, September 2012, page 114, available at www.investmentfunds.org.uk

2.12 Credit rating agencies also take account of the effectiveness of regulation. Moody's Bank Financial Strength Ratings (BSFRs) reflect banks' intrinsic safety and soundness (excluding the probability of state support in the event of their failure), and take into account the quality of regulation and supervision, as well as the strength of the economy and the stability of the financial system.[9] Having a credible regulator, in a relatively stable sovereign environment, is highly beneficial to firms in terms of how they are perceived by markets – a significant advantage to UK firms.

Costs to firms as part of the UK

2.13 The UK offers firms significant benefits in terms of their costs of doing business:

- the credibility of the UK as a sovereign and regulatory environment brings advantages to firms in terms of their cost of funding;
- the existence of a broadly consistent legal, regulatory and tax regime UK-wide minimises the additional operational costs incurred by firms who operate in more than one part of the UK;
- the scale of the UK regulator and the diversity of the levy base means that costs are spread widely; and
- the costs of UK-wide payment systems infrastructure are shared by a large number of firms.

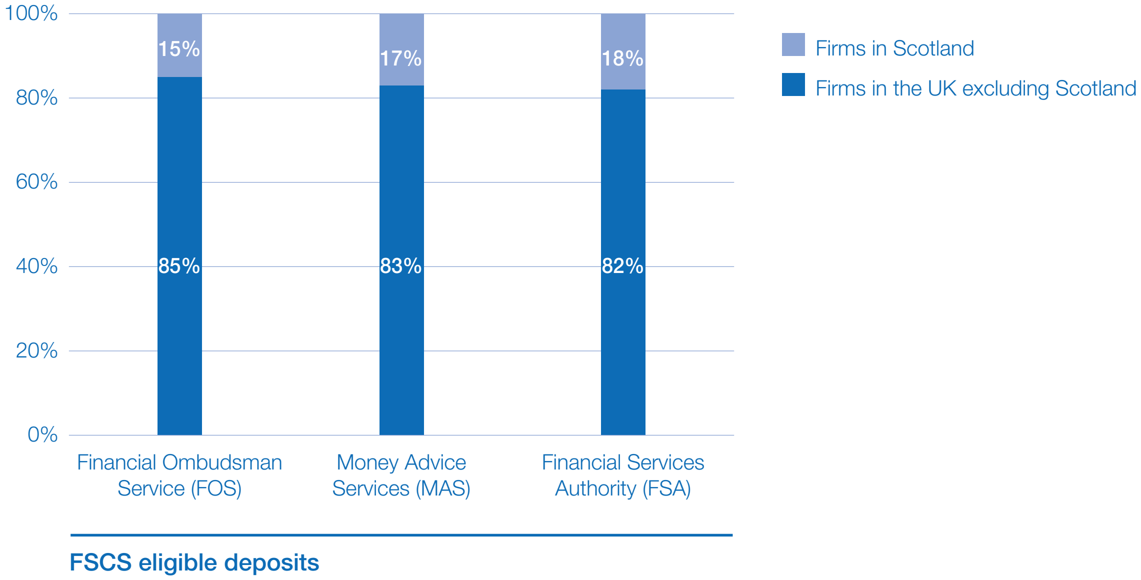
2.14 These benefits can be seen most clearly when compared to the counterfactual in which Scotland became a separate country.

9 *Scottish Independence: Issues and Questions*, Brian Quinn, David Hume Institute, 19 November 2012, page 6, available at www.davidhumeinstitute.com

Cost of regulation

2.15 The PRA and FCA are funded by levies on all UK authorised financial services firms. Firms are charged periodic fees, application fees and special project fees. If Scotland were to become independent, it would introduce new regulatory burdens for firms, be it a whole new regulatory system or separate conduct regulators, which would result in duplication of the costs to firms operating UK-wide. At present, Scottish firms contribute around 18 per cent (£83 million) of the FSA levy. Clearly, the introduction of two separate regulatory jurisdictions has the potential to increase the fixed costs of running the regulator (premises, IT, etc.) – the Scottish portion of which would have to be absorbed by Scottish firms.

Chart 2B: Industry funding of the regulatory regime



Source: HM Treasury analysis of FSA levy data

2.16 Firms with small margins are particularly sensitive to changes in regulatory costs. For example, credit unions are an important part of the financial services sector in Scotland: one in 20 people in Scotland are a member of a credit union.[10] Because of their small size, credit unions are particularly vulnerable to increased costs. Credit unions would therefore be particularly vulnerable to any increase in the cost of doing business arising from the disruption to the UK wide market.

Costs associated with new payments infrastructure

2.17 The payments infrastructure supports the money transmission system. English and Scottish banks operate on the same infrastructure which connects the account of a payer, via the sending bank's payments messaging, routing and processing systems, through a central processing and clearing and settlement system, to the receiving bank and the account of the payee.

2.18 The main infrastructure networks for sterling payments are Link (for ATMs), the cheque and credit clearing company, BACS (for direct debits, direct credits and the current account and cash ISA switching services), FPS (for real time on-line payments); CHAPS (for large value single same day transactions); and the card schemes like Visa, MasterCard, American Express and Diners Club. There are also payment systems tailored to trading platforms like the London Stock Exchange's Crest, central counterparty systems, and

[10] *Credit Unions in Scotland*, ABCUL Scotland, available at www.abculscotland.coop/credit-unions/creditunionsscotland

various automated clearing houses. Payments in euros and other currencies are handled separately (except the card schemes, which are multi-currency).

2.19 UK payment systems such as BACS and CHAPS only operate in sterling, and stop at the UK border. They are not interoperable with foreign systems. There is no payment system for euros in the UK. Euro and other currency payments are handled by EU, US and Asian payment systems. UK payment systems are not therefore geared up for foreign currencies or exchange risks. It would almost certainly not be practical to adapt them for this purpose. Specialist payment systems already undertake this role.

2.20 UK payment systems are owned and operated by scheme companies that are mutually owned by the member banks. BACS has 16 members, although some of these are historic (for example RBS, Coutts and Natwest are three separate members, but are all part of RBS Group). LINK has a larger membership, with 36 members. The payment systems operations are outsourced. Their headquarters and operations are based in England. Smaller banks that are not members connect to payment systems via agency agreements with a direct member. This is more efficient, saving substantial investment in IT systems and reducing credit and liquidity risks in the system. The collateral requirements are also lower.

2.21 The UK Government has announced major reforms to the governance of payments services, to ensure that they are competitive and operate to the benefits of their members.[11] However, if Scotland became independent it would potentially need a new payments infrastructure, which could be very costly. The scale of the costs in this area would depend crucially on the currency option:

- **monetary union:** if Scotland were to negotiate successfully to enter a sterling monetary union with the continuing UK, Scottish banks could continue to access the existing sterling payment systems as they do now. The Scottish central bank would not, however, have any say over payment systems that were overseen by the Bank of England;
- **a new Scottish currency:** new ATM and other cash distribution and handling services would have to be designed and contracted. The banks would also need to create new clearing and settlement systems for paper and electronic payments (except card schemes), or they might contract with existing providers of automated clearing house services to provide clearing services. It would almost certainly be necessary for the Scottish central bank to provide a real time gross settlement system to handle settlement of large value payments. The costs of this option depend on choices that would affect Scottish banks' existing payment messaging, routing and processing systems (for example, whether to keep the existing rather dated technical standards or migrate to the latest international standards). The costs of migrating to new payment message standards are likely to be very high (see below); and
- **joining the euro:** Scottish banks would need to adapt ATM systems and cash distribution and handling systems. They would join existing European euro clearing and settlement systems. They would be subject to Single Euro Payments Area legislation. This would require banks systems to be interoperable so that credit transfers and direct debit payments can be processed electronically from end to end (payer to receiver) anywhere in Europe. It would require migration to the latest technical standards and computer language (ISO 200022 XML) for electronic payment messages. This would require a major upgrade of Scottish banks' processing systems at substantial cost – the transition costs in other European countries are measurable

[11] See *Enhancing the regulatory framework for Payments Systems and services*, available at www.gov.uk

in hundreds of millions or billions of euros. Scottish firms of every size would also be required to submit payment instructions in the new electronic formats or pay someone to provide a conversion service. However, after transition, there would be benefits such as cheaper transaction costs and the development of new value added services (such as e-invoicing).

The Scottish financial services cluster as part of the UK

2.22 This section considers the extent to which the Scottish financial services cluster is sustained by links to the rest of the UK, and the potential impact should Scotland become independent. The Scottish financial sector is known for its expertise in banking, life and pensions insurance, and asset management. In particular, the Scottish sector has a high concentration of life insurance and pensions services, accounting for 24 per cent of the total UK sector, and is seen as the second most important centre outside of London and the South East. Scotland has had a long standing tradition in financial services, but has seen the development of a successful financial services industry cluster over the past two decades; the sector's size as a proportion of Scotland's GDP increasing by 84 per cent from 1998 to 2006. The significance and benefit of the cluster is further seen in its contribution to the growth of the Scottish economy, accounting for 45 per cent of the 15 per cent growth in output in Scotland over the period.[12]

Box 2C: The cluster effect

The notion of "clusters" is based on the development of geographically concentrated industrial sectors that yields competitive advantage for a certain territory or industry. The cluster effect is felt across the full range of industries – from IT to fashion and even restaurants. Financial services are prone to clustering due to the fact that they are heavily reliant on strong networks and skilled labour. Spatial proximity in financial services enables face-to-face networking, common labour markets and the pooling of expertise that are all fundamental to the financial services industry.

2.23 There are a number of benefits associated with successful financial services clusters:

- they encourage knowledge spillovers (the result of knowledge sharing that is not part of a commercial transaction);
- they enable easier communication and improve trust, which are particularly important for complex projects where face-to-face interaction is invaluable;
- the grouping of firms creates a perception of credibility to all the firms located in a cluster;
- they promote wider choice for firms and customers, driving competition;
- they reduce costs and time associated with transportation; and
- the concentration attracts an increased availability of input, for example, it makes a sector more attractive for skilled staff due to the wider choice of firms available.

2.24 Financial services clusters are also characterised by the growth in supportive industries that are required for firms to operate. The financial services industry in Scotland is a significant client for accountancy and postal service, and is also the driver for niche and specialist expertise in other sectors, such as accountancy and legal practices.

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[12] *Financial centres in peripheral Regions: the effect of the financial services industry on regional economy. The case of the Scottish financial cluster*, Mikel Larreina, June 2008, page 21

Sector	Sales to the Scottish financial services industry as a % of total sales of the sector	% of Scottish GDP
Postal Service	40.07%	0.6887
Accountancy Services	29.01%	0.6656
Other Business Services	19.37%	2.5669
Advertising	18.71%	0.1544
Computing Services	18.22%	1.4195
Owning and Dealing in Real Estate	18.11%	0.9607
Printing and Publishing	17.60%	1.1372
Market Research	19.96%	0.5759
Legal Activities	16.27%	0.9044
Telecommunications	15.93%	1.7259
Air Transport	13.38%	0.4052

Table 2A: Scottish industries highly dependent on the Scottish-based financial services industry, Average 1998 – 2003

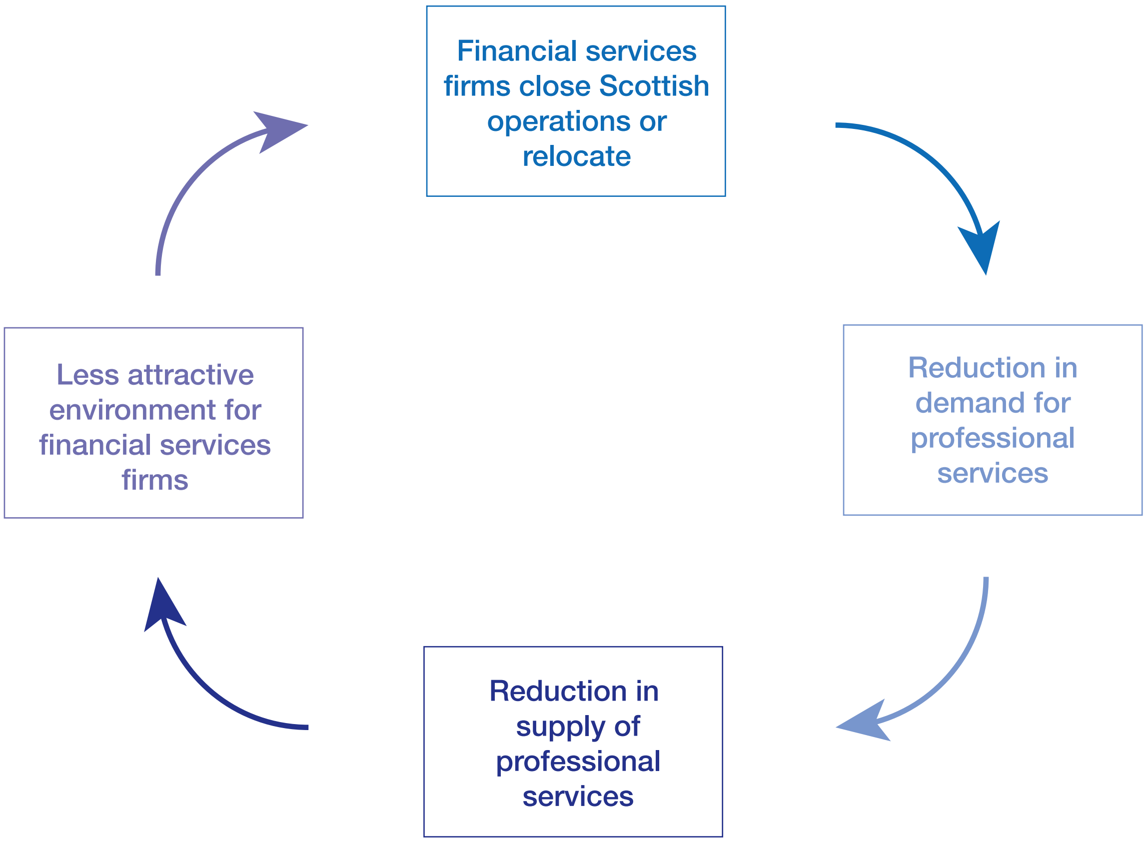
Source: Larreina, M (2008) Financial centres in peripheral regions: the effect of the financial services industry on regional economy. The case of the Scottish financial cluster.

Impact of independence on the Scottish financial services cluster if Scotland became independent

2.25 Every global firm determines its location strategy based on a wide range of factors, including considerations around cost and the skills of the workforce, political risk, access to markets, and the tax and wider business environment as well as reputational and cultural factors. It is very clear that as part of the UK, Scotland is considered to be a highly attractive location. Many firms also have strong historic and cultural links to Scotland.

2.26 As discussed, independence creates a series of factors that could reduce the attractiveness of Scotland as a location for financial services businesses and therefore act as an incentive for firms to consider locations elsewhere. The insight of cluster theory is that, even if only one significant firm leaves the cluster, this can cause harm to the rest of the industry. This is well illustrated by considering the potential impact on the professional and accountancy services industry in Scotland. As can be seen from Table 2A, the financial services sector is a large consumer of these services, and they are considered an advantage of the current position by industry; and a possible concern if they leave. The impact of firms leaving a cluster can be seen in terms of a negative spiral, illustrated in Chart 2C below.

Chart 2C: Risk of a 'negative spiral' undermining the Scottish financial services cluster



Financial centres in other small economies

2.27 There are a number of smaller economies that do run highly successful financial sectors. The factors that enable them to do so are highly case specific. As discussed in Chapter 1, a key advantage for Scotland under the current constitutional set up is that it has its own strong identity as a financial centre, with distinct advantages in terms of skills and location. But it is also part of the larger UK financial centre, which as discussed above is arguably the most important (and interconnected) in the world.

2.28 As shown by the case studies below, smaller financial centres can and do flourish when they take advantage of their natural advantages. Scotland is well placed – as a small economy that is part of the wider UK economy – to compete with these other major financial centres, and in particular to take advantage of the enormous opportunities arising in Asia. However, it would not be able to recreate all of the geographical and historical advantages of the states discussed below. To take the most obvious example, the development of Hong Kong and Singapore is closely tied to a geographical location which enables them to take advantage of the rapid development of the Asian economies. Switzerland attracts some business based on its long-established culture of banking privacy (albeit one which is now becoming more open), and reputation for strong economic fundamentals (as discussed in Chapter 1). A range of factors have enabled Luxembourg to take the preeminent position as a global asset management hub.

Singapore

2.29 Singapore's financial sector is small compared to the UK's (less than a sixth of the size) but it continues to grow strongly, mostly due to regional economic growth and wealth creation. Asian financial centres are well placed to finance Asia's investment needs, extend retail banking to the emerging middle-classes and cater for the new rich. The vast majority of Singapore's financial growth has resulted from increases in equity market capitalisation, and the Singapore Exchange (SGX) is recognised as a leading stock market in Asia and one of the world's leading derivatives exchanges. Singapore is the wealth management hub of Asia, and it is also a global booking hub for private banks whose clients want to register legal ownership of their assets in Asia.

2.30 Singapore is a highly competitive location, ranking third in the global competitiveness index and in the Global Financial Centres Index. It has been ranked by the World Bank as having "the most business-friendly regulation in the world" overall. Regulation in Singapore is also compliant with international standards (requiring only fine tuning to bring into line with the Basel recommendations[13]) which helped to shield Singapore from the worst of the financial crisis. The Singaporean authorities are also actively engaged in redesigning international financial regulation and are represented on the Financial Stability Board and the Basel Banking Committee of Banking Supervision.

2.31 In terms of future prospects, as a leading regional financial centre Singapore is well placed to benefit from economic and population growth in the region. It is also well-placed to tap into Chinese and Indian growth due to a sizeable ethnic Chinese and Indian population and an abundance of cultural ties. Singapore also looks set to benefit from growth in the global private wealth management industry as a leader in this sector. From 2008-9, wealth held by high net worth individuals (those with more than $1 million in financial assets) grew by 19 per cent. Continued growth in this sub-sector is likely to fuel the growth of Singapore's financial centre.

Hong Kong

2.32 While much smaller than London and New York, Hong Kong is by far the largest intermediary of foreign direct investment (FDI) flows in Asia, a large proportion of which is intermediation with China. Hong Kong is the primary regional centre for most international investment banks, insurance companies, private-equity firms and hedge funds. Moreover, professional services companies, including international law firms whose operations are restricted on the Mainland, have tended to use Hong Kong as a base for China-related operations. However, Singapore is also viewed as a very attractive alternative, particularly for hedge funds, where it may win business from Hong Kong.

2.33 Hong Kong's very strong links to mainland China are evident in a number of respects. The listings on the Hong Kong stock exchange mostly come from Mainland China or Hong Kong itself. Hong Kong is also the main destination of Chinese institutional investors that invest abroad. However its role as the leading intermediator of portfolio investment in the region does not depend on links with Mainland China.

2.34 As well as having a sizeable financial services cluster and a large pool of skilled expertise, Hong Kong's links with Mainland China is a major competitive advantage, in particular the many preferential market access rights it has been granted by the Chinese government. Hong Kong also has a very large pool of skilled expertise that is attractive to clients and investors. Hong Kong's robust approach to financial supervision should help to ensure financial stability.

[13] Basel recommendations can be found on the Basel Committee on Banking Supervision website www.bis.org/bcbs

2.35 Hong Kong and the UK compete in Hong Kong's areas of strength, including competition for listings from firms from Mainland China. It is clear that Scotland cannot replicate the geographical advantages of Hong Kong. However, Scotland as part of the UK does stand to benefit from Hong Kong's ongoing development. Hong Kong can give UK firms access to the Mainland market, including through setting up branches if they establish a Hong Kong incorporated subsidiary. Mainland firms that list in Hong Kong may also find it easier to list in the UK as their second market (given Hong Kong's legal system is largely based on the UK's).

Switzerland

2.36 Switzerland's banks have around $2 trillion in assets. It is a highly concentrated sector, dominated by two large players, UBS and Credit Suisse. Similarly, Switzerland's financial services trade balance is roughly a third of the UK's – at $17 billion, compared to $55 billion for the UK. Switzerland has a particularly large market share in:

- reinsurance – it has the third largest reinsurance business in the world;
- offshore wealth management – it is the largest centre in the world and Swiss domiciled institutions account for an estimated two-thirds of the sub-sector; and
- hedge funds – Switzerland's share in hedge funds is second only to the US.

2.37 Financial sector employment in Switzerland was affected little by the financial crisis. Switzerland continues to be highly competitive in terms of tax, regulation and government effectiveness and is perceived as a very low-risk and straightforward place to do business. Traditional Swiss attitudes to privacy give some Swiss financial institutions a competitive advantage where confidentiality is important.

2.38 As discussed in Chapter 1, Switzerland's macroeconomic fundamentals are extremely strong, adding a perception of Switzerland as a safe haven. Capital requirements in Switzerland are significantly tougher than the international minimum for all banks. However, as is clear from the Global Financial Centres Index, the UK remains a more competitive centre overall, and Scotland benefits from that as part of the UK.

Box 2D: Could an independent Scottish state emulate the success in asset management of Ireland and Luxembourg?

The cluster effect in the asset management industry is pronounced, with much of the business being arranged through face to face contact. For this reason, firms tend to establish a presence near their major client base, either through a branch or a representative office. The main cluster for UK asset management is therefore likely to remain in London. Scotland contains world class industries ancillary to the fund management sector. However at present, Scotland's fund management firms are readily able to draw on services from across the UK as well as those of Scotland itself. This enhances choice and competition. An independent Scottish state would only be able to draw from a much narrower pool.

Scotland currently shares a number of significant advantages with the rest of the UK, particularly around the international reputation of the regulatory jurisdiction, and the links into client base in London. If Scotland were to become independent, it would be difficult for it to recreate these benefits fully, particularly in the short term. However, it is possible Scotland could pursue an alternative route, and foster a different relationship with fund management.

Box 2D (continued): Could an independent Scottish state emulate the success in asset management of Ireland and Luxembourg?

For example, it would be open to Scotland to specialise as a fund administration hub. Fund administrators carry out the administrative business of running the fund. These include the full range of activities including accounting for the fund, settlement of purchases and collection of dividends, preparation of reports to shareholders, and regulatory compliance. Since 2008, some fund managers have sought to reduce costs by outsourcing their fund administration functions. However, there are few barriers to this at present, and Scotland arguably would be less well placed to develop this industry if it became independent because of the likely weakening of the relationship with the asset management hub in London. For example, specialists in compliance with UK regulation are likely to be recruited from the regulator itself or from other firms in the UK.

Alternatively or additionally, Scotland could establish itself as a low-tax jurisdiction in order to attract funds to be domiciled there, as Luxembourg and Ireland have done. There is significant value to be gained from attracting business for domicile. However, simply establishing as a domicile for funds is not guaranteed to generate significant additional employment (since most of the jobs are based where the fund is managed and administered). To compete with the established centres of Luxembourg and Ireland, an independent Scottish state would have to implement low rates of tax (with the concomitant fiscal implications). It would also have to renegotiate all of the UK's existing double taxation treaties. A number of jurisdictions are competing for domicile business (such as Malta an increasingly the Czech Republic). Ireland and Luxembourg already have platforms and specialists, and at present, one of the strongest factors in Scotland's favour as a potential domicile is proximity to the UK cluster and the expertise in London.

In summary, there is little upside for the asset management industry in Scotland from becoming detached from the main UK financial services cluster. If an independent Scottish state sought to foster an alternative asset management industry, there would be significant headwinds, and Scotland might struggle to be competitive in a global environment when compared to its current position in the UK.

Conclusion

2.39 Scotland has a flourishing and competitive financial services sector, creating large numbers of highly skilled jobs, and bringing economic benefits to Scotland and to the rest of the UK. As well as the advantages in terms of its skills, reputation, history and location, Scotland benefits from being in the same regulatory jurisdiction as London – the largest financial centre in Europe – and part of the wider UK regulatory environment.

2.40 If Scotland were to become independent, it would put this position at risk. Firms could experience higher funding costs as a result of being based in a new, smaller, higher risk state. This would be likely to be more pronounced in the banking sector, and have a real impact on the lending rates firms can offer to households and businesses. Firms could also lose the reputational benefits that come from being domiciled in the UK with a 'full service' regulatory framework, which is equipped to deal with the full range of financial services business.

2.41 Finally, as discussed above, the risk of increased costs and difficulties would have the potential to affect the Scottish financial services cluster negatively. Even a small number of firms redomiciling outside could have a wider impact on employment outside the financial services sector.

Chapter 3:
The UK domestic market

There is currently a single domestic market in financial services across the whole of the UK.

Scottish Financial Enterprise (SFE) reports that 90 per cent of their members' customers are in the rest of the UK. The analysis in this paper confirms this general point, and finds integration across other product classes. For example, 89 per cent of stocks and shares Individual Savings Accounts (ISAs) provided by Scottish firms were to customers based in the rest of the UK. Similarly, UK firms are important to people living in Scotland: 70 per cent of pensions products bought by Scottish consumers were bought from firms based in the rest of the UK.

At present, firms can easily provide services to customers wherever in the UK they are based. This position is highly advantageous to firms and customers in Scotland and the rest of the UK.

Were Scotland to become independent, it would put an international border in the middle of financial transactions and between customers and their accounts. International experience shows that borders reduce flows of goods, capital and labour, even where countries are members of single markets with low formal trade barriers. This phenomenon is known as the border effect.[1] There is currently a single regulatory framework covering the whole UK – and this position could not continue if Scotland became a separate country. Crucially, if Scotland became a member of the EU it would be required to establish its own financial regulator. Financial services are designed around the tax and regulatory system, and any divergence in this area would produce a significant border effect. For example:

- ISAs provide relief on income tax and capital gains tax levied by the UK Government; and they can only be sold to UK residents. If Scotland were a separate country, it would not necessarily be possible for Scottish consumers to put their money in ISAs provided by UK banks, or vice versa if an independent Scotland were to develop an equivalent scheme;
- attempts at EU level to create a single market in pensions have so far not succeeded, as a result of substantial differences between Member States in the areas of tax, labour law and social security. If an independent Scotland and the UK were to diverge in these areas, it would cause significant disruption to the pensions market; and
- credit unions currently make use of UK-wide networks to promote sharing of knowledge and pooling of resources. Diverging legal and regulatory structures would reduce the capacity of credit unions to take advantage of the benefits of networking across the whole of the UK.

[1] As discussed in Box 3A.

The integrated domestic market

3.1 The Scottish economy is highly integrated with that of the rest of the UK. 58 per cent of total exports and 71 per cent of total imports in Scotland are with the rest of the UK.[1] This integration is particularly marked in financial services. Scottish Financial Enterprise (SFE) report that 90 per cent of its members' customers are based in the rest of the UK.[2] Treasury analysis of Financial Services Authority (FSA) data also bears out this relationship. As can be seen from Chart 3A and 3B, there is a highly integrated market across most financial services sectors.

3.2 This single domestic market allows financial services firms across the UK to access a large, deep and liquid market that drives competitive advantage for both the industry and its consumers. It also enables firms to take advantage of the benefits that can be achieved in larger markets such as greater economies of scale and more efficient risk diversification.

3.3 Perhaps the most commonly cited examples are the large UK-wide financial groups such as the Royal Bank of Scotland (RBS), which is a Scottish registered and headquartered group which includes a number of separately authorised entities headquartered in the rest of the UK; and Lloyds Banking Group (LBG) which was formed through the merger of Lloyds TSB and Halifax Bank of Scotland (HBOS) in 2009.

3.4 However, integration is not limited to large banking groups; smaller firms also operate in a UK-wide environment. Institutions such as the National Health Service credit union have large numbers of members in Scotland and the rest of the UK. Credit unions UK-wide are supported by bodies such as the Association of British Credit Unions Limited (ABCUL), including through projects to help volunteers share expertise and take advantage of the benefits of being part of a wider network.[3] As discussed in more detail in the rest of this chapter, the trade in financial services between Scotland and the rest of the UK is extensive across all sectors, including mortgages, life and pensions products, and investments.

3.5 The degree of integration can also be seen in the ownership of financial businesses. The number of registered enterprises engaging in financial and insurance activities in Scotland in March 2012 totalled 1,865. From this, 1,625 were Scottish owned enterprises, 120 rest of the UK owned and 120 foreign owned. Scottish owned enterprises employed 52,080 workers in Scotland, rest of the UK owned enterprises employed 17,810 workers and foreign owned enterprises employed 19,870 workers. As is clear from these figures, non-Scottish owned enterprises are proportionately larger by employee size.[4]

Operational costs

3.6 The single UK market is beneficial to all firms in the UK as it keeps operational costs down. The creation of two markets, with completely separate legal, tax and regulatory regimes, would increase the cost of operating for firms providing services and products UK-wide. Firms have a number of fixed costs, including rent and utilities, payroll and costs associated with regulatory compliance. These costs are already affected to an extent by devolution, but would be likely to increase substantially under independence.

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1 HMT Analysis of Scottish National Accounts Tables – 2012Q2.

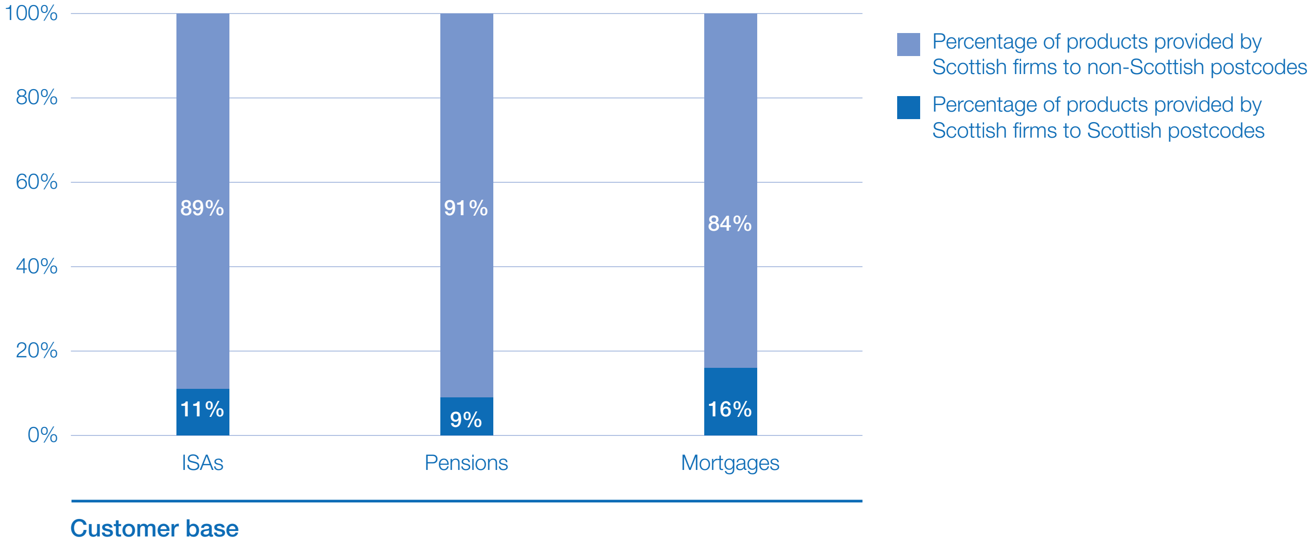
2 Speech by Owen Kelly, Chief Executive, SFE, at the Scotsman Conference, *A Question of Independence: The Economics of Independence,* June 2012.

3 *ABCUL Annual Report 2010-2011,* Association of British Credit Unions Limited, 2012, available at www.abcul.org

4 *Businesses in Scotland 2012,* Scottish Government, available at www.scotland.gov.uk

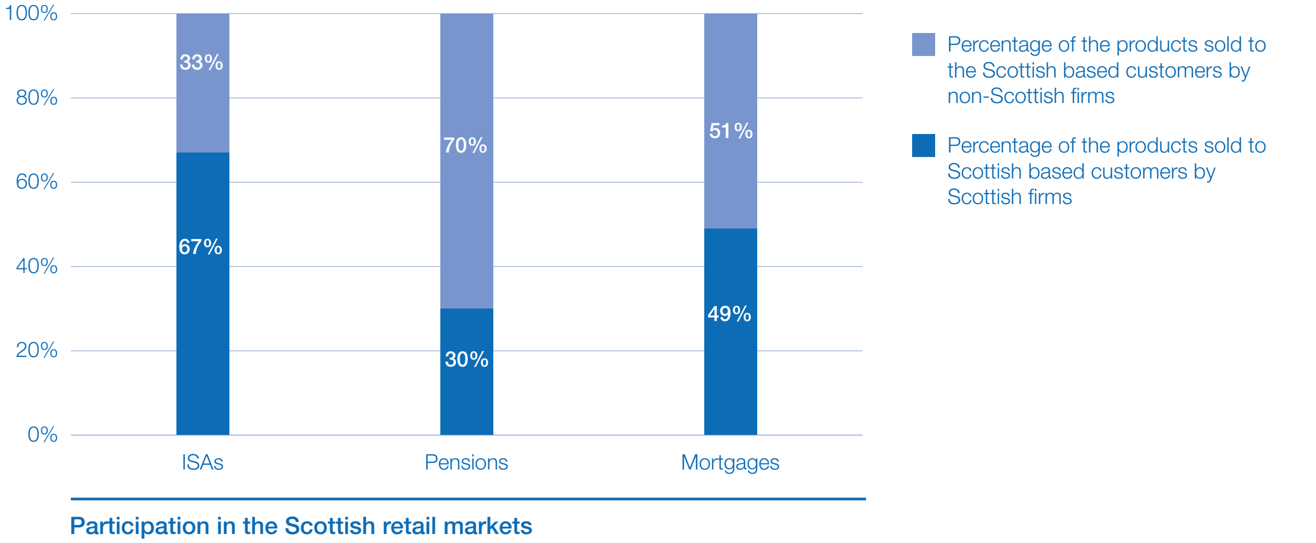
3.7 The operational costs involved include the screening and monitoring of borrowers; staffing requirements; the training of staff; and IT systems etc. All of these could be reasonably expected to be affected by independence. The creation of two markets that would be caused by divergence between the regulatory and legal environment of an independent Scottish state and the continuing UK would make it very difficult, if not impossible, for products to remain uniform across the whole UK. This would impact firms economies of scale by increasing the fixed costs associated with running parallel operations to provide products in both markets for the same number of customers.

Chart 3A: Scottish firms' customer base – selected products



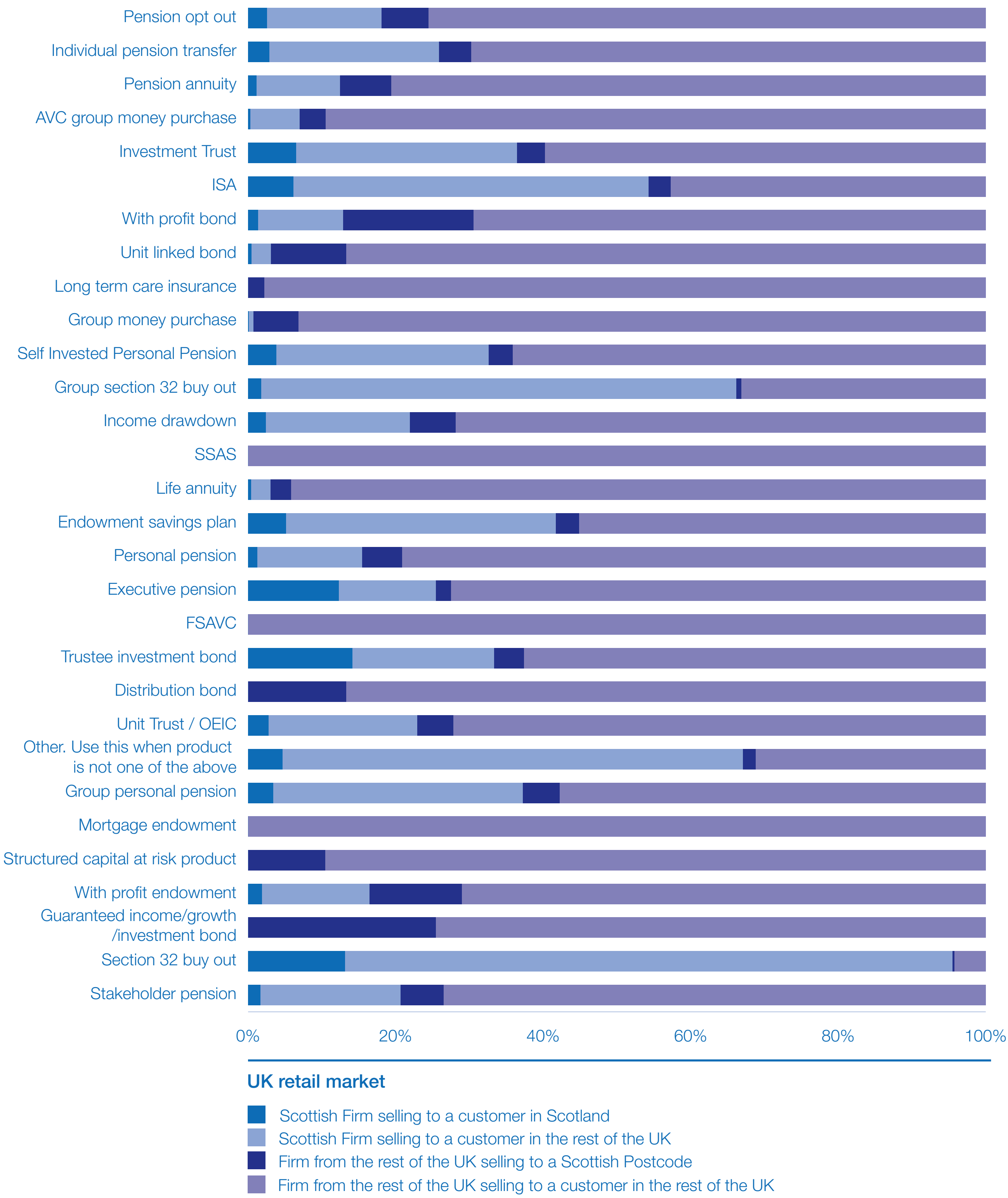
Source: HM Treasury analysis of FSA product sales data

Chart 3B: Participation in the Scottish retail market by firms from Scotland and the rest of the UK – selected products



Source: HM Treasury analysis of FSA product sales data

Chart 3C: Integration across the UK retail market



Source: HM Treasury analysis of FSA product sales data

Imposition of an international border

3.8 There is a single tax and regulatory framework across the whole UK which facilitates a single market in financial services. This means that once a firm is authorised to carry out business, it can operate in any part of the UK.

3.9 This section considers the possibility of the introduction of a border effect in financial services should Scotland become independent. The border effect refers to the fact that international borders reduce trade.

Box 3A: The border effect

Evidence from academic literature and global experience shows international borders reduce flows of goods, capital and labour, even where countries are members of single markets with low formal trade barriers. Lower-end estimates from the literature suggest regions trade around 2.5 times more with other regions within a country than internationally, after controlling for other factors. The impact on migration might be even larger. This border effect goes beyond the traditional measures of trade barriers (tariffs, quotas, transport costs etc.), suggesting shared history, culture, language and business networks play a role. Where countries have separated, there can be a rapid decline in trade between the new countries, as was seen when Czechoslovakia dissolved in 1992, although this does not appear always to be the case. Even where the decline is not immediate, over time diverging tax and regulation systems, and changing cultural and social norms, are likely to reduce flows of goods, capital and labour.[1]

[1] The seminal paper by McCallum in 1995 used trade data between Canadian provinces and US states, concluding trade between Canadian provinces is 22 times larger than between US State and Canadian provinces, after controlling for size and distance.

3.10 Despite the single market in financial services at EU level, there are some products and sectors where cross border trade is very rare. This is attributable to a wide range of factors, some of which would not apply to trade in financial services between an independent Scottish state and the continuing UK. For example, it is rare for mortgages to be sold cross border within the EU. One likely reason is that relative maturity of EU mortgage markets means that providers wishing to expand are likely to receive a better return on capital by looking beyond the EU to emerging markets. This factor would not apply to mortgage providers based in the rest of the UK who already lend to Scottish households and already have market penetration in Scotland.

3.11 However, there are other factors that would have a significant impact on the ease and cost of doing business between the two jurisdictions, which overall would be likely to reduce trade in financial services between the continuing UK and an independent Scotland. In particular, divergence between an independent Scottish state and the UK in their respective regulation, taxation and legislation frameworks would mean that separate products would need to be provided for the two markets. This would increase the costs and difficulties for firms operating within both an independent Scotland and the continuing UK.

3.12 There is an important difference between transferring tax powers to the Scottish Parliament under devolution and the creation of a separate Scottish tax system under independence. The Scottish Government currently has the legal powers to put in place different arrangements in relation to council tax and business rate. These powers are being extended by the UK Government through the Scotland Act 2012 to include Stamp Duty Land Tax, Landfill Tax and a 10 pence element of Income Tax. Under devolution the UK Government can therefore decide which tax powers to devolve and which work best on a UK-wide basis, ensuring that the system remains integrated across the whole of the UK. While an independent Scotland could choose to retain elements of the UK's tax system in the short-term, it is inevitable that there would be divergence over time, with a consequent impact on businesses operating within both jurisdictions.

3.13 The following sections highlight some of the impacts of a border on some specific sub-sectors. If Scotland became independent, it would create a number of obstacles that would disrupt the operation of the current domestic financial services market in the UK. As the following sections discuss, an independent Scottish state would be required to put in place its own regulatory environment and would introduce an international border between Scotland and the continuing UK. It is likely that over the medium to long term this would create barriers to firms doing business UK-wide. The impact of this would vary from sector to sector, but would in particular impose additional regulatory burdens.

Impact on the domestic regulatory environment

3.14 The single UK domestic market is possible because it is underpinned by a single regulatory environment. The current Scottish Government has argued that the future government of an independent Scottish state would ensure that there is a single regulatory environment covering Scotland and the UK. As a number of external commentators have suggested, this proposal does not appear to be workable.[5] If Scotland became independent, it would be required by EU law to establish a competent authority to regulate financial services provided in Scotland. It is theoretically possible that Scotland could, with the agreement of the rest of the UK, appoint the PRA and FCA as the regulators in Scotland.

3.15 However, this would not allow the FCA and PRA to regulate Scottish firms on a "UK wide" basis. The body of law applicable in Scotland and the rest of the UK would be different and the provision of services by Scottish firms to the rest of the UK would be done under passporting provisions of EU law. This would mean that Scottish firms providing services in the rest of the UK would have to be treated separately from other UK firms. For the regulator, it would have different functions in relation to Scottish firms depending on whether it was acting in its capacity as the "UK regulator" or the "Scottish regulator".

3.16 As discussed, if Scotland became independent it would be responsible for maintaining its own body of law in the area of financial services. In common with all other EU Member States, a Scottish Government may well wish to adapt European legislation to take account of unique Scottish characteristics and domestic policy. There are no examples of EU Member States who have simply adopted another Member State's body of law wholesale. This can be illustrated by looking at the different standards that already exist across the EU. EU Member States have separate legal regimes and different policy objectives. These differences lead to a significant variation in regulatory requirements imposed on firms. To date, EU requirements have tended to be "minimum harmonising",[6] meaning that minimum standards are set at EU level with discretion at Member State level to go further than the minimum. However, even where Directives are "maximum harmonising" (imposing identical standards on EU-wide) there is often discretion afforded to member states in implementation, in order to take account of local characteristics.

5 See the evidence from Owen Kelly (Chief Executive of Scottish Financial Enterprise) to the Lords Economic Affairs Committee on 24 October 2012 available at www.parliament.uk/business/committees

6 *Consumer protection in financial services,* Deutsche Bank, 24 May 2011, page 8 available at www.banking-on-green.com

Box 3B: Differences in regulatory approaches between EU Member States

There are significant differences in the regulatory approaches across the EU. For example:

- The FSA's Retail Distribution Review (RDR) is a key part of the UK's consumer protection strategy, aimed at establishing a resilient, effective and attractive retail investment market that consumers can have confidence in. The RDR was a response to specific problems in the UK's domestic market for financial advice. Unlike most of Europe, the UK has a large number of independent financial advisers. These divergent distribution models each bring their own conflicts of interest and merit different policy responses;
- Rules under the European Union's Markets in Financial Instruments Directive (MiFID) for client assets must take account of differences in Member State insolvency regimes. Here, due to the interface with domestic rules, the FSA did not consider the European framework to be sufficiently robust and has imposed additional requirements on firms;
- There are substantial differences in requirements around pensions between member states. For example, the UK and Ireland require the mandatory indexation of deferred pensions, whereas Germany and the Netherlands only require indexation to the extent that it is affordable;[1] and
- There are also substantial differences in arrangements for consumer redress across the EU. The UK's Financial Ombudsman Service (FOS) is responsible for addressing individual complaints that consumers and financial businesses have not been able to resolve themselves. The remit and powers of the FOS go further than that in some other EU Member States. If Scotland became independent it would be free to establish its own bodies – and the Scottish financial services regulator would need to put in place its own arrangements for engaging with these bodies.

[1] See *UK Pensions Regulation Compared*, National Association of Pension Funds, October 2008 available at www.napf.co.uk

3.17 Clearly firms can and do operate across borders. But the lack of a border within the UK is beneficial to the firms and customers across the UK. The evidence from the EU is that where there are separate legal regimes and divergence in domestic policy objectives, regulatory requirements inevitably differ. Following this example, in the medium to long term there would be likely to be significant divergence between an independent Scottish state and the continuing UK, reflecting diverging legal regimes, policy priorities and the composition of the sector, even if at the outset an independent Scotland adopted arrangements designed to mirror the UK's arrangements in order to minimise divergence in regulatory standards. This divergance would be likely to increase over time.

3.18 The establishment of Scotland as a separate regulatory jurisdiction would inevitably disrupt the operation of the UK-wide market. From the outset, firms would be required to "passport" between Scotland and the UK, and divergence in regulatory standards would mean that firms would be faced with the increased cost and difficulty of operating across two regulatory systems rather than one. These costs would inevitably increase over time as regulatory, legal and tax environments diverge, leading to increased marginal costs for UK firms operating in the Scottish market, and vice versa. The following sections discuss implications for particular sectors:

- general insurance;
- pensions and life insurance;
- retail investment; and
- credit unions.

General insurance

3.19 The UK insurance industry is the largest in Europe and the third largest in the world, accounting for seven per cent of worldwide premium income. The whole UK industry has over 1000 companies authorised to write general insurance business and over 3,000 professional insurance brokers distributing it. Over 300 insurers write long term savings, pension and protection products, and the industry employs 290,000 people.[7]

3.20 General insurance represents five per cent of all Scottish financial sector employment. The Scottish sector only totals five per cent of all general insurance services in Great Britain, and there are no major general insurers based in Scotland. There are a large number of firms with a significant presence in Scotland, such as Aviva and Prudential, as well as a large number of Scottish customers utilising the insurers based in the rest of the UK. However all of these firms have their head offices outside of Scotland.

3.21 Insurance products are designed to dovetail with and supplement the legal, regulatory and welfare systems. At the moment, these systems are mostly UK-wide and reserved, allowing for universal insurance products to be fit for purpose throughout the whole UK. Two independent states would inevitably diverge in these areas, potentially resulting in the need for separate products for the two markets.[8] This would affect economies of scale and the ability to diversify risk over a larger market for the larger insurance firms.

3.22 Insurance products are also based around the tax regime. If Scotland became independent, there could be differences in this area. Insurance Premium Tax (IPT) is a tax on General Insurance premiums which the insurer is responsible for accounting for and paying. There are two rates – a standard rate of 6 per cent, and a higher rate of 20 per cent for travel insurance and some insurance for vehicles and domestic/electrical appliances. Most long term insurance is exempted from the tax, as is reinsurance, insurance for commercial ships and aircraft and insurance for commercial goods in international transit. Premiums for risks located outside the UK are also exempt, but they may be liable to similar taxes imposed by other countries. In the UK, insurance business also is generally exempt from VAT (with the consequent issue of irrecoverable VAT) though the extent of the application of that exemption to "ancillary activities" is a live issue. Firms and employers would need to consider what they would need to pay and what they would need to do in order to deal with any changes to tax regimes if Scotland became independent.

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7 *UK Insurance Key facts,* Association of British Insurers, September 2012.

8 This point has been made by the British Insurance Brokers Association at their Annual Scottish Conference in November 2012, accounts of which is available at www.postonline.co.uk (*BIBA: Scottish independence could pose problems for cross-border trade*, 20 November 2012)

Box 3C: Case study – the motor insurance industry

The motor insurance industry is the largest class of insurance in the UK, with Gross Written Premiums of £9.5 billion in 2009.[1] It is characterised as a highly competitive but highly concentrated market with very small profit margins. There is very little cross-border business in motor insurance in the EU, with 1.7 per cent of premiums from companies set up via the rules on freedom of establishment and only 0.6 per cent of premiums written through the free provision of services.[2] The main obstacles to cross-border business are the need to establish a local presence in a market and the differences that exist between contract law in Member States, which both add cost and risk to an industry with very tight profit margins.[3]

The legal rules on motor insurance are UK-wide but Scottish independence would increase the likelihood of divergence. The "continuous insurance enforcement" rules stipulate that if "you're the registered keeper of a vehicle it must be insured or declared as off the road (SORN)"[4] The UK has a minimum requirement of third party insurance for drivers. However, the option would be open to an independent Scottish state to change the level or type of protection legally mandated, for example adopting the Norwegian model of vehicle insurance.[5] In effect, the prospect of divergence would increase the cost for insurers to operate in both a Scottish and continuing UK markets. For example, having to develop new products and added regulatory compliance.

The effect on industry would be determined by the size, type and intentions of a firm, but it can be concluded that insurers that wished to continue to access the whole of the current UK market would be met by higher costs and resources. Additional costs could be a driver behind firms leaving the market as profit margins are very small and evidence shows firms leaving the market due to the lack of profitability.[6] The size of the Scottish market may not be cost effective for smaller and medium insurers and brokers based in the rest of the UK, impacting the level of competition in motor insurance in Scotland. Overall, the most likely outcome of this is that any increased costs would be passed on to consumers.

1 *Bringing Profitability back from the brink of extinction, a report on the UK retail motor insurance market*, Ernst & Young, 2011, page 17

2 *Retail Insurance Market study, MARKT/2008/18/h*, Final Report by Europe Economics, March 2010

3 *Retail Insurance Market study, MARKT/2008/18/h*, Final Report by Europe Economics, March 2010

4 See www.gov.uk/vehicle-insurance

5 Norwegian vehicle insurance requires the vehicle to be insured rather than personal vehicle insurance that is required in the UK

6 See *Bringing Profitability back from the brink of extinction, a report on the UK retail motor insurance market*, Ernst & Young, 2011

Pensions and life insurance

3.23 The pensions industry has a crucial role to play in supporting people in old age.

3.24 Pensions and life insurance products are designed to be fit for purpose for the market in which they operate. Pension schemes are subject to a number of social and labour laws that set the rules on benefits, contributions, access, investments, and management and information requirements of the pension. These differ across nations. For example, 13 OECD countries have mandatory or quasi-mandatory private pension systems, which are otherwise voluntary in other states.[9] These are all areas in which divergence could occur if Scotland were to become independent from the UK.

9 See *OECD Pensions Outlook 2012*, available at www.oecd.org

3.25 Taxes and charges on pension schemes, both at the contribution and benefit stage, are also national. For example, current UK-wide legislation for pension contributions allow for tax relief for the employer and the employee, pensions are free of capital gains tax, and allow for a 25 per cent lump sum tax free to be taken upon retirement, with the remaining pension income taxed as earnable income. Conversely, the rates and systems of tax relief vary in other countries, such as Ireland, where different rates for relief are determined by the age of the policyholder. Attempts at EU level to create a single market in pensions have so far not succeeded: a result of substantial cultural and regulatory difference between Member States.[10] If Scotland were to become an independent state, pension providers would have to ensure that their products address the change in tax systems and any differences that develop in pension policy.

Box 3D: The impact of a border on occupational pension schemes

Significant issues would be created for occupational private pensions schemes if Scotland were to become independent from the UK. Currently, employers are able to run defined benefit and hybrid pension schemes UK wide. However, if Scotland were to leave the UK, schemes that are provided from Scotland to the rest of the UK and vice versa would become cross-border. As indicated in the recent report published by the Institute of Chartered Accountants of Scotland (ICAS), an independent Scotland as a separate EU Member State would create substantial additional burdens for any schemes that would become cross-border.

There are two key differences to the treatment of domestic and cross-border schemes – their funding and regulatory requirements. Schemes operating across borders are required to be fully funded in respect to their technical provisions under the EU Pensions Directive (IORP), which is not required for domestic schemes. Work by ICAS shows that a large number of UK pension schemes do not currently meet the required funding levels and if they were to become cross-border: "the potential impact on funding requirements for employers operating defined benefit or hybrid schemes across the UK is likely to be substantial".[1] Additionally, UK regulation requires cross-border schemes to undertake actuarial variations annually rather than every three years, as is the case for domestic schemes. In practice, this would mean that schemes that would become cross-border would be met with additional regulatory and cost burden.

1 *Scotland's Pensions Future: What pensions arrangements would Scotland need?*, ICAS, April 2013, p. 17

3.26 Similarly, life insurance products must also take account of tax treatment, regulation and supervision, contract law, marketing law, and accounting rules.[11] One example is tax, where the UK applies the Income-minus-Expenses system that taxes the profit gained by the company and policy holder and the chargeable regime, which taxes the policyholder on additional rate liability. However, Ireland for example currently does not tax the interest made on life insurance policy cash values.[12] Another example of policy difference is the tax relief to premiums paid on policies, which the UK does not provide but there are a number of countries that do under specific limitations.[13] Additionally, life insurance is regulated at

10 See *Towards Pan-European Pensions,* European Financial Services Round Table report, October 2004.

11 See *Financial integration within the European Union: Towards a single market for insurance,* Beckmann et al, 2002.

12 See *the taxation of life insurance policies in OECD countries: Implications for tax policy and planning,* available at www.oecd.org

13 See *the taxation of life insurance policies in OECD countries: Implications for tax policy and planning,* available at www.oecd.org

the national level setting the conditions for licensing, investment and supervision of the industry. There has been increasing harmonisation at the EU level in recent years, but there are still differences between the regulatory and tax systems of Member States that result in there not being a single market for life insurance products.

3.27 As indicated, the bespoke nature of pension products, and to lesser extent life insurance products, means separate markets require different products. Scottish independence would require pension and life insurance products to be fit for purpose for either the continuing UK market or the independent Scottish market. This could involve significant structural and organisational changes for firms that would come at a cost[14] that firms could choose to pass on to consumers.[15] Customers deciding which firms to use for their long-term savings and investments products, including pensions, put a high value on trust and certainty. Prolonged uncertainty could have a harmful effect on the sector, and represent a serious source of concern to customers.

3.28 This paper considers private sector pensions. The issue of pensions, including public sector and state pensions – of vital importance to the people of Scotland and the rest of the UK – will be further examined in later papers in the Scotland analysis programme series.

Retail saving and investment products

3.29 If Scotland became independent, it could have a significant impact on competition in the retail saving and investment sector. As discussed above there would need to be separate regulatory regimes in Scotland and the UK, and it is inevitable that over time there would be divergence. If such divergence took place, not only would firms operating across both jurisdictions need to be separately authorised, each "approved person" (for example, each Independent Financial Advisor (IFA)) working for the firm would need the approval of both regulators; and would also need to comply with separate requirements imposed by each regulator.

3.30 This could create a strong incentive for firms to consolidate their business in the same regulatory jurisdiction as their products and clients. This is particularly the case because retail investors may prefer to invest in funds managed locally, and where they are familiar with the tax and regulatory system. In effect, it is likely that the retail market would be divided in two, with neither market able to support as many participants as before.

3.31 Obstacles to savings and investment products are based primarily on the differences in tax treatments and national legal requirements of products. For example, cash ISAs are a UK product that provides relief on income tax and capital gains tax for UK residents. Similarly, investment products are designed around the tax system of a state, such as UK investment trusts, which enjoy exemptions from certain capital gains taxes[16] if they meet the conditions for approval, including the requirement to be a resident in the UK.[17] While it is conceivable that, if Scotland became independent, the governments of an independent Scotland and the continuing UK might be able to negotiate arrangement to waive tax on specific savings products provided by firms based in the other jurisdiction, clearly this would create significant additional complexity (for consumers and for firms themselves).

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[14] *Scottish independence,* Pensions Age, February 2013, available at www.pensionsage.com

[15] How costs are passed on to consumers is explored in more detail in Chapter 4.

[16] See HM Revenue & Customs Manuals, para CTM47110, available at www.hmrc.gov.uk

[17] See HM Revenue & Customs Manuals, para CTM47205, available at www.hmrc.gov.uk

Box 3E: Would access to the London Stock Exchange be affected?

A significant factor in the UK investment market is the London Stock Exchange. The London Stock Exchange is one of the world's oldest exchanges, founded in 1801. At the year-end 2012, it had a market capitalisation of $3,397 billion,[1] making it the third largest domestic stock exchange in the world and the largest in Europe. Currently, there are 95 companies based in Scotland listed on the main market and Alternative Investment Market (AIM) with a market value of £81,399 million.[2]

Both UK and non-UK companies can trade on the London Stock Exchange. The rules and requirements for securities applying to be admitted to the Official list of the FCA (in its capacity as the UK Listing Authority (UKLA)) in order to trade on the London Stock Exchange are mainly consistent for both UK companies and non-UK. There are a small number of associated listing rules on reporting for premium listed issuers that are UK specific (principally regarding the content of the annual report) but they are not substantial.[3] In effect, not being based in the UK should not create any barriers to access the London Stock Exchange.

One area for potential change and costs is the requirement of an independent Scotland to have a competent authority for all applicable EU Directives in regards to listing (a UKLA equivalent). The specifics for such a body are not possible to determine at this moment and would be a matter for an independent Scottish Government.

There would potentially be a number of practical impacts that might need to be addressed. In particular, Scottish based companies listed as "UK companies" may be required to reclassify their listings. For example, a Scottish based company might have to reclassify itself as "Scottish" rather than "UK". This has the potential to effect investors who posses UK mandates. In some cases, funds have specifically "UK only" mandates. In this scenario, investors would be required to make a choice to redraft their mandate at a cost or divest itself of the "Scottish" portion of their UK assets.

1 *2012 WFE Market Highlights*, World Federation of Exchanges, January 2013

2 *All Companies on the London Stock Exchange*, London Stock Exchange, January 2013

3 Listing Rules now apply certain of these rules also for overseas issuers – for example requiring a "comply or explain" statement against the UK corporate governance code.

Credit unions

3.32 The imposition of a border would be likely to have an impact on credit unions. At present, credit unions in Scotland and the rest of the UK have access to UK-wide initiatives that promote sharing of knowledge and pooling of resources. Credit unions UK-wide are supported by the bodies such as the Association of British Credit Unions Limited (ABCUL), including through projects to help volunteers share expertise and take advantage of the benefits of being part of a wider network.[18] ABCUL have also worked with the Department for Work and Pensions to promote initiatives to share back offices and put in place arrangements for a shared current account. Credit unions have partnerships with the Money Advice Service, delivering face to face advice. In October 2012, the Unite union announced plans to establish a network of credit unions to help to provide credit to households and businesses.[19]

18 *ABCUL Annual Report 2010-2011,* Association of British Credit Unions Limited, 2012, available at www.abcul.org

19 *Unite plans network of credit unions in challenge to payday* lenders, the Guardian, October 2012.

3.33 By contrast, there is little transfer of expertise and resource pooling between credit unions in UK and Ireland, largely because of differences in currency, legal and regulatory frameworks. As the legal and regulatory structures of an independent Scotland and the continuing UK diverged, the capacity of credit unions to take advantage of the benefits of networking across the whole of the UK would be likely to diminish.

Conclusion

3.34 The UK single market in financial services is heavily integrated and important to the sector, and is facilitated by the consistent regulation, legislation and taxation frameworks throughout the whole of the UK. If Scotland became independent these frameworks would likely diverge, creating two separate markets for financial services. This could impact the sector in a number of ways:

- the creation of two markets would require firms to provide separate products for Scotland and the rest of the UK, and would come at a cost to industry;
- firms would lose the economies of scale from operating on a UK-wide basis, which would also increase costs for industry; and
- smaller and medium sized firms would find it harder to access the UK-wide market as a result of the increasing costs and difficulties of working in two regulatory jurisdictions.

Chapter 4: Protecting the interests of households and businesses

The financial sector provides essential credit and financial services to households and businesses, from the role of banks lending money to business, to independent financial advisors who help individuals save for retirement. The current UK-wide market creates a number of benefits for households and businesses as consumers of financial services.

The UK has well-functioning arrangements for protecting consumers of financial services that ensures there are consistent standards across the whole UK. The benefits that these bring would be more difficult to achieve if Scotland left the UK.

For example, the Financial Services Compensation Scheme (FSCS), funded through levies on a large and diverse levy base, and backed up by the Government, compensates eligible depositors, investors and insurance policyholders if a firm fails. Unless the sector restructured significantly, the Scottish retail deposit market would be highly concentrated, and if a large bank were to fail the scheme would struggle to compensate depositors. In an independent Scottish state, FSCS-eligible deposits in Scottish institutions would be over 100 per cent of Scotland's GDP, representing a significant contingent liability of the state – and a much more significant proportion than in the UK as a whole.

The UK market has a "critical mass" providing customers with greater choice and competition in financial services and products. The large single market allows households and businesses to access financial products and services throughout the whole UK. This would be put at risk by the introduction of a border, potentially leading to less choice and competition. For example, 48 per cent of adults in Scotland currently have an Individual Savings Account (ISA) that would not be available in its current form if Scotland separated from the UK.

The existing UK environment also helps to minimise costs for financial services firms. For example firms can spread risk and subsidise products and services over the whole UK, such as free credit accounts, which 94 per cent of all adults in the UK have access to. This would be more difficult under Scottish independence, and in some cases costs to industry would increase and be passed on to consumers. For example, mortgages where even small increases in costs can create very significant impacts for household finances. Even a one per cent rise in effective mortgage rates would cost the average UK household with a 75 per cent loan-to-value mortgage just under £1,750 in increased payments in the first year.[1]

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[1] The UK average house price according to the ONS is £233,000. An assumed 75 per cent mortgage means the househould would owe £174,750. One per cent of this gives the estimate £1,747.50.

4.1 Financial services are important to households and business in a range of ways, from the role of banks lending money to businesses, to independent financial advisers who help individuals save for retirement. More widely, a well-developed financial sector supports the wider economy, and experience shows that "there is clear and well established evidence that bigger and deeper banking systems go hand in hand with more advanced economic development."[1]

4.2 **The first half of this chapter discusses the UK's arrangements for protecting consumers of financial services.** Recent scandals – such as the misselling of Payment Protection Insurance (PPI) by banks – make clear that markets for financial services can work to the detriment of consumers. It is essential to have effective regulation, as well as arrangements for compensation and redress when things go wrong. Currently in the UK there is a consistent framework underpinning the whole UK market, which provides certainty to consumers. Responsibility for consumer protection would be fragmented if Scotland became independent, significantly reducing this advantage.

4.3 **The second half of the chapter discusses the "critical mass" that exists in the UK domestic market at present.** It explores the advantages that this brings to households and businesses in Scotland and the rest of the UK. It discusses how these advantages would be lessened by the fragmentation of the domestic UK market that would result if Scotland became independent.

The UK's consumer protection bodies

4.4 Underpinning the current UK domestic market are a number of bodies that ensure that, no matter where an individual lives in the UK, they can expect the same standard of consumer protection:

- the Financial Services Compensation Scheme (FSCS), which compensates eligible depositors, investors and insurance policyholders if a firm fails;
- the Pension Protection Fund (PPF), which pays out to members of defined benefit pension schemes if their scheme is no longer able to pay out;
- the Financial Conduct Authority (FCA), the new regulator which will police the behaviour of firms;
- the Financial Ombudsman Services (FOS),established under the Financial Services and Markets Act 2000 (FSMA) as an independent service for resolving disputes between consumer and firms; and
- the Money Advice Service (MAS), established under the Financial Services Act 2010 to provide financial education and advice to consumers.

4.5 There are three distinct advantages that arise from the existing UK framework as a whole. First, it means that there are consistent standards of consumer protection across the UK market. Second, the consumer protection bodies are large, well-funded organisations, able to take a consistent approach across the UK market, creating efficiencies. Finally, the compensation bodies (the FSCS and the PPF) are able to pool risk across a large and diverse market. These advantages are discussed briefly below, before turning to a discussion of the bodies themselves. All of these advantages would be greatly reduced by the fragmentation of responsibility for consumer protection that would result if Scotland became independent.

[1] *Access to Finance,* World Savings Bank Institute, 2004, page 5.

Consistent standards underpinning consumer choice in the UK market

4.6 At present, if an individual buys an investment product from a firm based anywhere in the UK, or puts their money in a UK bank, they can be sure of a consistent set of standards. They can get generic advice on the whole UK market from MAS. They can be sure that the provider of the product is subject to clear standards on treating customers fairly set by the FCA. They know that if they have a dispute with the firm, that dispute can be settled by the FOS, widely seen as one of the most effective such mechanisms in the world. Finally, if the firm fails, the consumer can have the confidence that there is a well-funded compensation scheme, the FSCS, which can cover any eligible claims.

4.7 These common standards of consumer protection underpin the UK domestic market. Consumers can have certainty about the level and extent of coverage across the UK and which institutions are responsible for delivering consumer protection.

4.8 Differing standards of consumer protection can be a significant cause of confusion and concern to consumers, which can act as a significant barrier to cross-border transactions. A study by YouGov on behalf of the FSA in 2010 found that: “The vast majority of respondents (86 per cent) in the main survey felt that crossborder transactions carried some form of risk with them above and beyond the risks involved in buying UK based financial services and products ... Over two thirds (68 per cent) thought that if something went wrong that it would be difficult to obtain redress, 63 per cent felt that the product would not be as well protected as a similar product in the UK and 61 per cent said the providers would not be as well regulated as they are in the UK.”[2] The study found that consumers’ willingness to buy products varied from country to country, and that consumers were most willing to buy products from Ireland.[3] Nonetheless, it is clear that clarity and consistency about consumer protection measures is important to consumers, and is a key driver of their decisions in purchasing financial products.

4.9 If Scotland were to become independent, it would mean that a large number of the transactions between financial services firms and consumers that currently take place would become cross-border, creating uncertainty for consumers. As well as being a negative outcome in itself, differences in standards of consumer protection are an important driver of the border effect discussed in Chapter 3. As discussed later in this Chapter, the introduction of a border is likely to act as a barrier to the provision of products into the Scottish market, reducing the choice available to Scottish consumers.

Cost effective organisations that have the benefit of scale

4.10 The consumer protection bodies discussed in this Chapter are funded through levies on one of the largest and most diverse financial services industries in Europe. They are large, well-resourced organisations that cover the whole financial services industry, UK-wide. The existing system is therefore relatively cost effective. If Scotland were to become independent, it would need to make a number of decisions about what structures to put in place to provide consumer protection. In some cases it might wish to duplicate the UK’s arrangements or establish equivalent bodies. In other cases, it might wish to put in more limited or more extensive provisions.

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[2] *Consumer Appetite for Crossborder Shopping in Financial Services: A Report Prepared for the FSA*, Final Report, YouGov, 17 April 2010, page 26-27.

[3] *Consumer Appetite for Crossborder Shopping in Financial Services: A Report Prepared for the FSA*, Final Report, YouGov, 17 April 2010, page 21.

4.11 For an independent Scotland and the continuing UK to set up duplicate or parallel bodies would be less efficient and cost effective overall than the current position in which there is a single set of bodies serving all consumers. In other words, should Scotland become independent, it would be more expensive to achieve a level of consumer protection equivalent to that which currently exists. The bodies discussed below have a number of fixed costs (i.e. costs that would not be reduced if they were responsible for protecting a smaller population of consumers), and other costs which would be reduced only slightly, for example:

- some of the costs associated with infrastructure, premises and head office;
- research of product lines and consumer protection issues in line with developments in the market;
- response to Government policy initiatives such the introduction of pensions auto-enrolment and simple products; and
- costs associated with maintaining websites and developing publication materials.

4.12 Some of the costs are scalable, and would be reduced for UK institutions if they no longer served Scottish consumers. For example, the FOS would no longer be expected to raise awareness of its role among Scottish consumers, and MAS would only be required to print information leaflets for consumers in England, Wales and Northern Ireland. But if there were two sets of consumer protection bodies operating over the market where currently there is only one, this is likely to result in greater costs overall.

4.13 In both the continuing UK and an independent Scotland, this inefficiency would have to be addressed either through decreasing the extent of the services provided by these bodies, recouping the costs by increasing levies on industry (which would be likely to be passed on to consumers), or through Government subsidy (resulting in costs to taxpayers).

Well-funded compensation arrangements

4.14 The UK's arrangements for compensating consumers of financial services are funded by levies on a large and diverse financial sector, and the UK Government has the fiscal capacity to provide the necessary liquidity to ensure that schemes can always pay out to eligible consumers. If Scotland were to become independent, the Scottish sector would be much smaller and less diverse; and unless it restructured itself dramatically, it would be highly concentrated. This would create significant difficulties for the risk pooling and management schemes. This is discussed in detail below in relation to the FSCS and PPF.

Box 4A: What scope is there for "shared institutions" to protect consumers in Scotland and the UK if Scotland becomes independent?

Some commentators have suggested that if Scotland were to become independent, it might be feasible and desirable to "share" some of the UK's institutions, such as the Bank of England and the prudential regulator. As discussed in Chapter 3, it is not viable to share the prudential regulator, as EU law would require Scotland to put in place its own regulator if it became independent.

However, it is worth considering whether this would be a viable option for the consumer protection bodies. In some cases (such as the FSCS), EU law requires Member States to maintain their own scheme, and it would not be possible for the continuing UK and an independent Scotland to maintain "joint" arrangements. In some other cases (such as MAS), joint schemes would be legally possible, but there would be significant difficulties. And in any event they could not fully recreate the advantages of the existing arrangements.

First, there would be problems of accountability if the consumer protection bodies had to be "shared" between two independent states. Governments of independent states are responsible for putting in place and maintaining the legal and regulatory framework for consumer protection. All of the bodies discussed in this section are constituted under UK law, and are accountable to the UK Parliament; and senior appointments are made by UK ministers. It would be difficult to see how the same bodies could also be simultaneously accountable to the Scottish Parliament and independent Scottish ministers.

Second, the consumer protection bodies would need to adapt to the legal and regulatory frameworks in the countries they operated. As discussed in the case study on MAS below, this would in effect require them to develop separate policy for an independent Scotland and the continuing UK, to be implemented separately. This would mean that unless the whole legal and regulatory framework of Scotland the continuing UK were identical, and remained so over time (which, as discussed in Chapter 3, seems unlikely), there would still be different protection standards between an independent Scotland and the continuing UK. Having to develop and maintain two sets of policies for two markets would clearly result in additional costs overall, as discussed elsewhere in this chapter.

Overall, it is unlikely that the "sharing" of institutions would recreate the existing advantages of the UK constitutional framework, and the problems of accountability mean that they are unlikely to be sustainable in the longer term.

Individual bodies

4.15 This section discusses in more detail the advantages that arise from the existing UK-wide framework in respect of each consumer protection body, and how those advantages may be reduced should Scotland become independent, resulting in a fragmentation of responsibility for consumer protection.

Financial Conduct Authority

4.16 The Financial Conduct Authority (FCA) is the new regulator of financial services firms, and is responsible for making markets work well so consumers get a fair deal. The FCA was established by the Financial Services Act 2012. The FCA will take a more proactive, interventionist approach to regulating conduct of business, using its expertise to judge where consumer detriment is most likely to occur, and intervene on a forward-looking preventative basis. It will have a single overarching strategic objective to ensure that markets function well. The three operational objectives are promoting effective competition in the interests of consumers, securing an appropriate degree of protection for consumers, and protecting and enhancing the integrity of the UK financial system.

4.17 Recent scandals, such as the widespread misselling of payment protection insurance (PPI), highlight the detriment consumers can suffer in the financial services sector. The UK-wide jurisdiction of the FCA means that it will be able address consumer detriment wherever it arises in the UK. These challenges would be much more difficult to meet if the UK market – and therefore the FCA's jurisdiction – is fractured into two smaller markets.

4.18 The FCA's powers and remit are wide. However, it is worth highlighting an example of how effective consumer protection could become more difficult if Scotland became independent. Since the Financial Services Act 2012, consumer groups are now able to make "super complaints" to the FCA about competition and consumer protection matters. The FCA must publicly respond to these complaints, setting out its proposed course of action, if it agrees. This will help to ensure swift action to address features of the market that may be disadvantageous to consumers.

4.19 However, the FCA will only have jurisdiction over the UK market. If Scotland were to become independent, it would not be possible for the FCA to address issues that arise as a result of the conduct of the Scottish firms. This would make it difficult to address issues of detriment that arise because of features of the combined Scotland-UK market. Overall, this would be likely to contribute to the creation of separate markets with different standards, which overall work less well for consumers.

The Financial Ombudsman Service

4.20 The Financial Ombudsman Service (FOS) is the official independent expert in settling complaints between consumers and businesses providing financial services. It was established under the Financial Services and Markets Act 2000. The FOS deals with complaints about the full range of firms including banking, insurance, mortgages, pensions and financial advice.

4.21 Throughout the year, the FOS carries out a range of awareness-raising events across the UK, including extensive work in Scotland. There were a range of events during 2012, from the ombudsman joining advice workers and community volunteers from across the Scottish Highlands and Islands at Citizens Advice Scotland's annual Highland Gathering in March, to publishing money related tips in conjunction with Family Life, the lifestyle magazine for parents in Scotland. This work has led to a relatively high level of consumer awareness about the FOS's work. According to the FOS's most recent review, awareness of the FOS stands at 75 per cent for Scottish consumers – the same figure as for England and Wales, and higher than the figure in Northern Ireland (54 per cent).[4] Nine per cent of people who complained to the FOS were based in Scotland,[5] roughly in proportion to the size of the population.

4.22 If Scotland became independent, Scottish customers would not automatically be able to obtain redress through the FOS. The FOS provides dispute resolution and redress arrangements for all UK customers of UK financial services firms. In practice, this also includes firms that are based elsewhere in Europe but which establish branches in the UK, as these generally "opt in" to the jurisdiction of the FOS.

4 See *Annual Review*, Financial Ombudsman Service, 2012, page 144, available at www.financial-ombudsman.org.uk

5 FOS annual review 2012, page 90.

4.23 An independent Scottish state might wish to put in place in its own alternative dispute resolution mechanism, and if it had succeeded in obtaining EU membership, it is likely that it would be required to do so.[6] The most obvious method would be through the creation of body analogous to the FOS. The issue of whether an independent Scotland would have an ombudsman's service, and if so how it would be funded, is an important question and one which industry has asked the Scottish Government to answer.[7]

4.24 Having separate arrangements for consumer redress would mean that a customer of the same bank would receive different treatment depending on whether they were based in Scotland or the continuing UK. Even if the two redress systems were initially identical, the legal framework would be likely to diverge over time. This is another example of how the current domestic market would fragment into two separate markets (subject to different regulatory and redress frameworks) if Scotland were to become independent. As discussed above, the effectiveness of dispute resolution arrangements is one of the key concerns for consumers buying financial products across borders.

4.25 In summary, at present, consumers can expect a single standard of consumer protection wherever in the UK they are based. And the protection offered by the FOS is considered to be among the best in the world. This would be undermined if the UK were to fragment into two separate markets, leading to worse outcomes for consumers.

The Money Advice Service

4.26 The Money Advice Service (MAS) is an independent service, set up by the Government, to help people make the most of their money. It gives free, unbiased money advice to everyone across the UK – online, over the phone and face to face. The service is paid for by a statutory levy on the financial services industry, raised through the FCA. Its statutory objectives are to enhance the understanding and knowledge of members of the public about financial matters (including the UK financial system), and to enhance the ability of members of the public to manage their own financial affairs. At present, MAS provides advice about the whole UK market to anyone based in the UK.

4.27 The Money Advice Service carries out extensive work in Scotland. The funding for debt advice in Scotland is £2.7 million for 2012-13 and the same again for 2013-14, approximately 10 per cent of the overall debt advice delivery budget. During the period April 2011 to March 2012, MAS distributed 195,000 publications to consumers in Scotland, including 41,672 parent's guides to money and 12,990 redundancy handbooks.[8]

4.28 If Scotland became independent, it would not be required (under EU law or otherwise) to establish a consumer financial education body if it did not wish to do so. An independent Scottish Government could decide not to establish a scheme, but this would have a negative effect on consumers in Scotland, depriving them of a free source of advice on money and debt. Alternatively, an independent Scotland could choose to establish its own scheme, which could be funded through levies on industry, through taxation, or through other means. But this would duplicate the fixed costs of the existing scheme, leading to greater overall costs to firms, which could be passed on to consumers. It would also reinforce "separateness" of the UK and Scotland markets, adding to the border effect discussed in Chapter 3.

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6 The Alternative Dispute Resolution Directive, which is currently under negotiation, will require this.

7 *CBI Scotland's response to the Scottish Affairs Committee's call for evidence on the second phase of its inquiry into 'The Referendum On Separation For Scotland',* CBI Scotland, May 2012, available at www.cbi.org.uk

8 Information provided by the Money Advice Service.

Box 4B: Case study – the feasibility of "sharing" the Money Advice Service

As discussed in Box 4A, some commentators have suggested that should Scotland become independent, it would be able to share some institutions with the UK. It is worth considering MAS as a case study in why this would be problematic.

MAS is involved in the delivery of UK Government policy. Where there are new Government policy initiatives (such as requirements for auto-enrolment in pension schemes; the universal credit; the development of simple products), information about how to access and engage with these policies is provided through MAS. Working across two jurisdictions, MAS would need to increase its current capacity in policy implementation significantly.

MAS has teams who develop policy and generic advice on the UK market. With two separate markets, subject to diverging regulatory requirements and divergent tax regimes (as discussed in the previous chapter) it would in practice be necessary to maintain two separate policy units to deal with the two different markets and sets of products.

There is currently a single dataset maintained for products across the whole of the UK (for example, with data on pensions and welfare and financial services). Given the divergence in the market, MAS would need to maintain two separate data sets – one for an independent Scotland and one for the continuing UK.

As a result, if attempts were made to put in place a MAS that was "shared" between the UK and an independent Scotland, it would be significantly less efficient than a single scheme operating across a single domestic market. Even for the delivery of routine advice, it would be necessary for the MAS to operate as two systems, significantly increasing the cost of delivering advice. These costs could be met either by increasing the overall levy (i.e. on firms north and south of the border), or through a reduction in the service offered.

Financial Services Compensation Scheme

4.29 The Financial Services Compensation Scheme (FSCS) is the UK's deposit guarantee scheme. It pays compensation up to £85,000 where a financial services firm is unable to meet claims against it. This discussion focuses on the deposit taking class.[9] However, the issues raised also apply to the other classes of financial services covered by the scheme. Further data on coverage of these financial products is set out in Annex A.

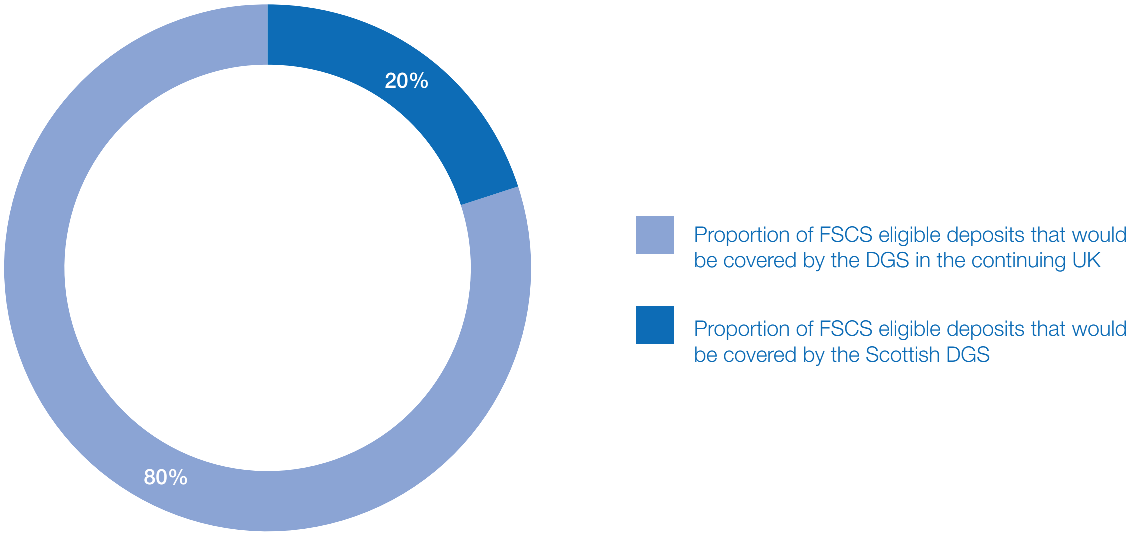
4.30 The UK is required to have a deposit guarantee scheme by the EU's Deposit Guarantee Schemes Directive (DGSD), which also sets out the amount of compensation that must be paid under the scheme. If Scotland were to leave the UK, it would also be required to have a deposit guarantee scheme (DGS) covering firms that are authorised in Scotland to accept deposits (those of customers in Scotland and customers of branches established outside Scotland – where a firm establishes a subsidiary in another EU Member State, that subsidiary is covered by the DGS in the Member State in which it is established). There is international consensus that having an effective, well-funded deposit guarantee scheme, is crucial for maintaining consumer confidence in the financial system and protecting financial stability.[10]

[9] Other classes of financial product are also covered – data is set out in the statistical annex

[10] *Thematic Review on Deposit Insurance Systems,* Financial Stability Boards, February 2012 available at www.financialstabilityboard.org

4.31 Payouts under the scheme and the operational costs of running it must be funded entirely by levies on industry, although the Government may lend money to the DGS in order to help fund large compensation payouts. The UK Government lent around £20 billion to the FSCS during the recent financial crisis. Under European law an independent Scottish state would not be able to "share" the UK's deposit guarantee scheme, such that it covered firms authorised in both Scotland and the continuing UK. On leaving the UK, the population of UK firms would therefore need to be split between the new Scottish deposit guarantee scheme and the FSCS. At present "Scottish" firms account for 19.8 per cent of the UK market and firms based in the rest of the UK for 80.2 per cent.

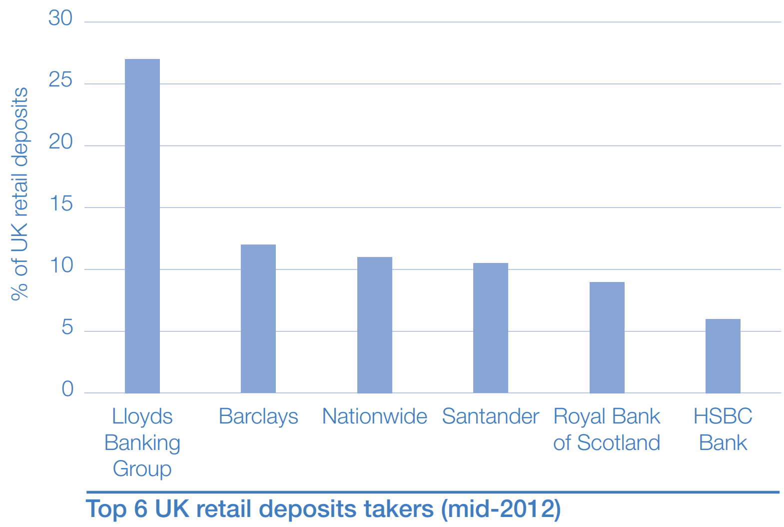
Chart 4A: FSCS coverage in Scotland and the rest of the UK in the deposit taking class



Source: Treasury analysis of FSCS levy data

4.32 In the UK at present there are a number of large deposit takers, meaning that the risk if one of them fails is spread over the remaining firms. In an independent Scottish state, by contrast the deposit taking sector would be very highly concentrated (assuming no change to the current profile of the sector).

Chart 4B: Concentration in the retail deposit taking sector



Source: datamonitorfinancial.com

4.33 The principle benefit of the UK in this area is risk-pooling. When one deposit-taker fails, the others are liable to contribute to the cost of compensating eligible depositors.

4.34 As is clear from Chart 4B, the UK retail deposit taking sector is fairly concentrated: the largest six firms have around 73 per cent of the market share.[11] Lloyds Banking Group, the largest has, just over 25 per cent of retail deposits; but within this there are a number of deposit takers that are separate legal entities (Lloyds TSB Scotland PLC, Bank of Scotland PLC and Lloyds TSB PLC). By comparison, the Scottish retail deposit market is far more concentrated: it would be dominated by two large banks – Bank of Scotland, and Royal Bank of Scotland.[12] If one of these were to fail, almost all of the costs for compensating the depositors would fall on the remaining large firm.

4.35 If Scotland were to be become independent, it could create particular difficulties for the Financial Services Compensation Scheme (FSCS). In an independent Scottish state, FSCS-eligible deposits held by Scottish firms (and which would therefore be covered by the Scottish compensation scheme) would be over 100 per cent of Scotland's GDP, representing a significant contingent liability of the state – and a much more significant proportion than in the UK as a whole, as can be seen in Chart 4C. As was clear from the 2008 financial crisis, where there are doubts about the ability of the sector to meet claims through the compensation scheme, it can be necessary for governments to step in to guarantee deposits in order to prevent deposit flight.

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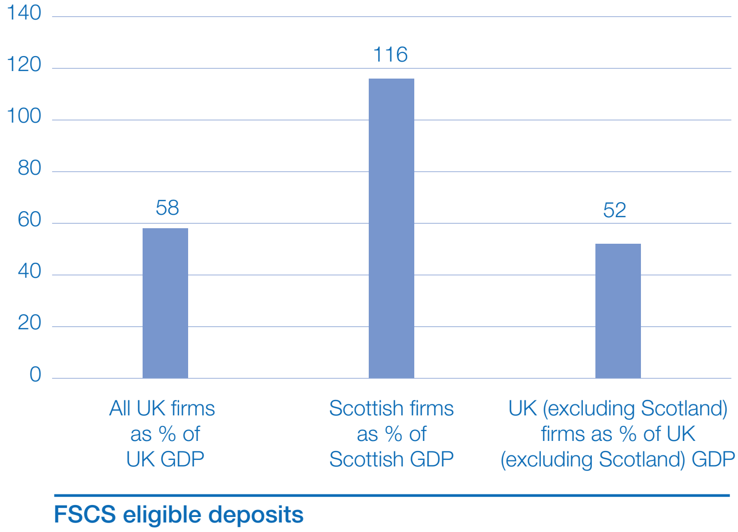
11 *Barclays and Lloyds increase their shares of the UK retail deposit market*, Matia Grossi, Datamonitor, 31 October 2012 available at www.datamonitorfinancial.com

12 As discussed in Chapter 2, RBS and Bank of Scotland are subsidiaries headquartered in Scotland. So even though they form part of wider groups (RBS group and Lloyds Banking Group respectively), which could continue to be headquartered in London if Scotland became independent, the Scottish subsidiaries would be subject to supervision by the Scottish authorities and would be covered by the separate Scottish deposit guarantee scheme. The only way that this could be avoided would be for the groups to restructure such that they were no longer headquartered in Scotland. As discussed in Chapters 2 and 3, this would have negative effects on the size and international prestige of Scotland's financial sector.

Chart 4C: Contingent liability for the state arising from the FSCS



Source: HM Treasury analysis of FSA data

4.36 These factors are likely to reduce overall consumer confidence in the scheme: this would apply to an independent Scottish scheme and to a lesser extent to the scheme in the continuing UK (which is likely to be larger and more diversified, with contingent risk shared by a greater number of scheme participants). A useful comparison can be drawn with the impact on Ireland's deposit guarantee scheme, which suffered from a loss of confidence among retail deposit takers when the capacity of the scheme to meet claims against it was called into question in 2008-2009.

4.37 A study conducted for the FSA into consumer awareness of the FSCS found that coverage of foreign-owned firms was a significant source of confusion for consumers.[13] Fragmenting the UK's deposit guarantee scheme would add additional complexity which would be ultimately detrimental to the interests of consumers both in an independent Scottish state and the continuing UK.

4.38 As well as being harmful to consumer protection, these factors would likely make an independent Scottish state a less attractive place to be based as a deposit taker. As discussed in Chapter 1, there are two possible outcomes from this heightened risk in an independent Scottish state. First, the Scottish sector could reduce in size, either because firms react to the heightened risk by moving their operations elsewhere, or because government of an independent Scottish state takes steps to reduce the size of the sector (and the risks to consumers, and the associated the contingent fiscal risk). However, this would have negative effects on employment, GDP, and the provision of banking services in an independent Scotland, and would undermine the Scottish financial services cluster discussed in Chapter 2. Alternatively, the sector could remain as it is and firms, taxpayers and consumers would be required to absorb the costs associated with heightened risks to financial stability. As described in Chapter 2, these risks are acute.

[13] *Consumer awareness of the Financial Services Compensation Scheme,* Dave Skelsey, Strictly Financial, January 2009, page 37.

4.39 It would not be possible under EU law for an independent Scottish state to "share" the UK's deposit guarantee scheme. Some of these factors may be mitigated (in part) if an independent Scottish state were to join a European banking union with a mutualised deposit guarantee scheme across the euro are and other members who "opt in", as discussed in Box 1C. However, the details of the banking union are not yet clear, and would not be consistent with the declared preference of current Scottish ministers for preserving the "UK-wide" market.

Pension Protection Fund (PPF)

4.40 The Pension Protection Fund (PPF) protects millions of people throughout the UK who are members of eligible defined benefit pension schemes. If the sponsoring employer has a qualifying insolvency event and there are insufficient assets in the scheme to cover benefits at the same level as PPF compensation, the scheme will enter the PPF, which will pay compensation to members. The PPF is currently paying 360,000 individuals.[14] The PPF is funded by a pension protection levy, the remaining assets of schemes transferring to it, funds recovered from insolvent employers and investment returns.

4.41 If Scotland became independent, members of defined benefit schemes in Scotland would not be covered by the PPF. If Scotland succeeded in obtaining EU membership it would be required to protect the member benefits in defined benefit occupational pensions.[15] The most obvious method would be through the creation of a guarantee fund analogous to the PPF.

4.42 It would be difficult for an independent Scotland to maintain an effective standalone scheme. The UK has a large number of defined benefit schemes, meaning that the risk is spread. In an independent Scottish state there would be a much smaller number of providers (a rough estimate, based on the number of providers whose billing address is in Scotland, puts the figure at around seven per cent of the total number of schemes).[16]

4.43 If a sponsoring employer of a large scheme became insolvent in an independent Scotland the costs would be spread across a much smaller levy base, increasing the costs for other schemes. This would be in addition to any costs arising from the new institutional and regulatory framework needed to supervise pensions in Scotland, an issue highlighted by industry.[17] These costs could be passed on to customers, or the Scottish Government could "top up" the scheme. Alternatively, the Scottish Government might propose remaining within the PPF (Luxembourg has an arrangement that its schemes are covered by the German PSV). EU law permits the sharing of pensions compensation schemes such as the PPF, whereas the DGSD does not allow this for deposit guarantee schemes. However, its ability to do so would be subject to negotiation with the government of the continuing UK.

4.44 Overall, it is clear that for similar reasons to the FSCS, the current UK structures provide significant advantages in terms of protecting individuals' pensions. Separation of Scotland's pension protection arrangements would create major additional challenges.

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[14] *Annual Report and Accounts*, Pension Protection Fund, 2012, available at www.pensionprotectionfund.org.uk

[15] This is required by Article 8 of the Insolvency Directive.

[16] Of the 6432 schemes covered by the PPF, 459 have a scheme billing address in Scotland. Data provided by the PPF.

[17] *Scottish independence will create 'considerable costs' in pensions sector*, Adam Cadle, 5 March 2013, available at www.pensionsage.com

The "critical mass" of the current UK market

4.45 This section of the chapter explores the advantages brought to consumers by the "critical mass" of the domestic UK market. There is currently a large domestic UK market in financial services, which brings significant advantages for households and businesses in Scotland and the rest of the UK:

- **diversity and choice** – the UK market currently offers consumers a wide range of products;
- **competition and contestability** – the UK has a large number of firms and consumers, which in principle create the necessary conditions for effective competition; and
- **costs to consumers** – the UK market has a number of features which operate to drive down costs to consumers. For example, it provides greater capacity for firms to subsidise products and services, such as free credit accounts and basic products, which would not be as great in smaller, less efficient markets.

4.46 There are challenges in all of these areas, and the Government is taking active steps to improve competition in financial services. However, all of these benefits would be significantly more difficult to achieve if Scotland became independent.

Diversity and choice

4.47 Chapters 1 and 2 show that at present the UK is an attractive place for firms to be based. These chapters also highlight how independence would create a number of factors that would likely reduce the attractiveness of Scotland as a place to do business. This could encourage firms to move their operations out of Scotland. Chapter 3 shows that the divergence between the regulatory, legal and tax systems of an independent Scottish state and the UK would introduce barriers to the single domestic market, resulting in financial services firms having to provide different products in the two markets.

4.48 Splitting the Scottish market from the UK market would therefore act as a barrier to entry to the Scottish market. For many firms, it may simply not be cost effective to maintain a Scottish operation as well as a UK operation, as to do so would require them to comply with two sets of regulatory requirements and standards, including those arising from the consumer protection bodies discussed in the first part of the this chapter.

4.49 At the moment, it is easy for firms based in Scotland to enter the market in the rest of the UK, and vice versa. It would be more difficult for firms to do this if Scotland became independent, making both markets less contestable. Competition in contestable markets is driven by an incumbent's "fear" of competition. For example, if a market is contestable, any large profits would act as a signal to new firms to enter the market and undercut existing firms. This potential applies downward pressure on price and generally results in lower profit margins for firms. Research by the IMF has shown that open and contestable financial systems have led to greater product innovation, lower costs of financial intermediation, more access to financial services and enhanced stability in the sector.[18]

[18] *Competition in the Financial Sector: An overview of competition policies,* IMF Working Paper, 2009.

4.50 There are two potential impacts from firms withdrawing from the Scottish market:

- there could be less competition in the Scottish market, meaning that Scottish consumers would have less choice in financial services and products. Research and theory indicate that strong competition leads to decreasing prices, higher quality products, greater innovation, more access to financial services and enhanced stability in markets.[19] Assuming that demand remains constant, a reduction in supply would lead to products becoming more expensive or of lower quality; or

- assuming firms remained located where they were and market share stayed the same, the Scottish market would be very concentrated, particularly in retail banking,[20] which could lead to a less contestable market. Less contestable markets see more costs passed on to consumers.[21]

Products that cannot be provided over two markets

4.51 A key issue is that there are some products that cannot be provided in two markets. For example, UK ISAs exist only because the UK Government provides tax relief on these products (see the case study in Box 4C). The cost of developing a specific product for Scottish consumers could be prohibitive in some circumstances given the relatively small size of the market. This could lead to some firms withdrawing products, resulting in fewer firms or products in the Scottish market, which would be likely to have the effect of driving up prices and/or driving down quality.

Box 4C: Case Study: Individual Savings Accounts (ISAs)

ISAs are tax-efficient savings and investment products that can be used to save cash or invest in stocks and shares in the UK. Consumers pay no income tax on the interest or dividends received from an ISA and any profits from investments are free of Capital Gains tax.[1] The current annual investment allowance is £11,520, with £5,760 allowable as cash savings.

ISAs are designed to give customers the potential for medium to long-term growth and the flexibility to change investment whenever needed. They also provide customers with instant access to savings to supplement their income as financial needs change over time.[2] They are a popular savings product in the UK, with 24,356,000 holders of ISAs in the whole UK as of April 2011, a total of 49.4 per cent of all adults in the UK. Of these, 2,028,000 were Scottish consumers,[3] who represented 48.1 per cent of all adults in Scotland.[4]

[1] Stocks and shares ISAs incur a 20 per cent flat rate charge on cash deposits and a 10 per cent non-reclaimable tax on dividends paid within an ISA.

[2] Fixed rate ISAs are available but customers are only tied up for a few years.

[3] HMRC Statistics, *9.9 Individual Saving Accounts (ISAs) – Number of individuals subscribing to ISAs in 2010-11, by country and region*, available at www.hmrc.gov.uk

[4] HMRC Statistics, *9.12 Individual Saving Accounts (ISAs) – Number of individuals holding ISAs by country, region and market value, and as a percentage of the UK adult population, as at end 2010-11*, available at www.hmrc.gov.uk

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[19] *Competition in the Financial Sector: An overview of competition policies,* IMF Working paper, 2009.

[20] See *SME Access to finance Survey Report,* Scottish Government, 2012, available at www.scotland.gov.uk

[21] See, for example, *Solvency II Cost Benefit Analysis*, Ernst & Young, June 2011, page 9.

Box 4C (continued): Case Study: Individual Savings Accounts (ISAs)

According to recent Product Sales Data (PSD) collected by the FSA, there were a total of 607,221 stocks and shares ISAs sold in the last financial year.[5] Of these, 229,617 were recorded by postcode and showed that firms based in Scotland sold 89 per cent of their ISAs to customers in the rest of the UK and 33 per cent of the ISAs opened by Scottish consumers were with non-Scottish firms.

Scottish independence would mean that an independent Scottish state would need to consider its own incentives for tax free savings. It could decide to follow a pattern similar to that of the UK. But if Scotland became independent, Scottish customers would no longer be able to invest in UK ISAs and get UK tax relief. ISAs are specifically a UK product that provides tax relief to UK residents. It is therefore a requirement to be a resident in the UK (or a crown employee) to invest in an ISA. The current legislation surrounding ISA products stipulates that in the event a UK resident with an ISA leaves the UK, they are no longer eligible to put money into that ISA.

These impacts would inevitably have an effect on Scottish consumers holding a UK ISA account. It would also mean that Scottish residents would not be able to open new UK ISA accounts. If current arrangements persisted, Scottish consumers would be likely to start being taxed on income held in current UK ISAs. The availability of tax-advantaged saving products in an independent Scottish state would be determined by the policy choices taken by the Scottish Government. But consumers in Scotland would not be able to continue to use ISA products (in their current form) available to consumers in the rest of the UK.

The status of existing ISAs is one of the issues that would need to be resolved as part of any transitional arrangements should Scotland become independent. It is worth noting that holders of ISAs who become non-resident for tax purposes can, in some cases, keep the investments in the ISA but cannot add to them. Whether an individual is able to keep the account open whilst a non-UK resident is determined by the account provider. It is also the case that the interest earned on the investments in an ISA are only tax free in the UK and is usually taxable in non-UK countries.

5 PSD only captures new sales of stocks and shares ISAs (not cash, insurance or fixed-income) and does not collect information on transfers or redemptions.

Box 4D: Case Study: National Savings and Investments (NS&I)

NS&I is one of the largest savings organisations in the UK, representing approximately 7.5 per cent of the UK retail savings market, with over 26 million customers and more than £100 billion invested.[1] Of this, there are 1.6 million customers in Scotland who have a total of £5.5 billion saved in NS&I products.[2] NS&I does not have a branch network and has been progressively developing low cost direct channels by telephone and internet. Currently, the Post Office is NS&I's major distribution partner, with over 11,500 outlets providing a fact-to-face channel for NS&I customers for certain products.

As a Government department and Executive Agency of the Chancellor of the Exchequer, its principle activity is to finance part of the UK Government's borrowing by selling savings and investment products to retail savers and investors. When customers invest in NS&I products, they are lending to the Government who, in return, pays interest, stock market linked returns or prizes for Premium Bonds. Monies received by NS&I are passed to the National Loans Fund (NLF), which provides a 100 per cent HM Treasury guarantee. It provides simple, deposit-based products with some products providing tax relief to the consumer.[3]

The powers governing the way NS&I products are structured and managed come from UK primary and secondary legislation and all strategic decisions regarding products require Ministerial consent.[4] As a result, NS&I products are UK specific products that would either be more difficult to access or ultimately unavailable for consumers in Scotland in the event of Scottish independence.

NS&I's products may only be purchased using a UK bank or building society account, i.e. via a debit card issued by or cheque drawn on a UK bank or building society. Where customers nominate an account to receive payments, the nominated account must be a UK bank account. Currently payments are only made in pounds sterling. In addition, the Direct ISA and Direct Saver accounts are only available to UK residents.[5]

Whilst NS&I products (other than Direct ISA and Direct Saver) can be purchased by those outside the UK, there is added difficulty for consumers accessing them. Current rules require the purchaser to check whether local regulations allow them to purchase and hold NS&I products. Purchasers are also asked to check the tax position where they live and to provide their Tax Information Number (TIN) if they live in the EU.

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[1] More information is available from the NS&I website, www.nsandi.com/about-nsi-who-we-are

[2] NS&I have defined customers as those having a positive balance with an open holding and excluding customers who only hold under £10 in their Residual Account. Figures taken from *NS&I DWH via Business Objects. data as at 13/2/13, saved in x\new\analysis\media team\Feb13 Scotland customers*.

[3] NS&I have 10 products, though four are currently not on sale to new customers. They are best known for their Premium Bonds but also offer a variety of other products. Four products are offered on a "tax privileged" basis and are unique to NS&I. NS&I's product mix varies depending on financial market conditions and the Net Financing target set for it by HM Treasury.

[4] For example, NS&I are required to prepare their accounts under HMT direction, legislated for in section 7(2) of the Government Resources Accounts Act 2000. See www.nsandi.com/about-nsi-our-performance-our-annual-report-and-accounts

[5] NS&I product details can be found at www.nsandi.com/savings

4.52 As can be seen from these two examples, there are some products which cannot be offered across two markets. As discussed in Chapter 3, while it is conceivable that approaches could be found for individual products that would enable them to be marketed cross border, these are likely to create significant additional complexity (for consumers and for firms themselves), which risks fragmenting what is currently a single, domestic market.

Could a more localised "Scottish" industry develop if Scotland became independent?

4.53 There is the possibility that independence would lead to a smaller more localised market in Scotland. For example, if the disincentive to operating in the Scottish market led to firms leaving, this could create space for new challengers that were more "Scotland focused". Under this scenario, firms would provide specialised products and services that were tailored and more responsive to Scottish households and businesses. The likelihood of this scenario would be increased in the event of the withdrawal of one of the big firms with a large market share.

4.54 However, smaller Scotland-focused providers in this scenario may find it more difficult to access the low rates available in the wholesale funding markets compared to the large banks, impacting their ability to offer lower prices.

4.55 In addition, Scottish consumers would encounter added difficulties in accessing products and services that were previously available to them and, as indicated previously, some products would not be available in the Scottish market at all. Some products and services in the UK, like ISAs, are only available to UK residents and some UK products prove harder to access cross-border, such as National Savings and Investments products.

4.56 It is not possible to state definitively what products would be available to Scottish consumers in the event of independence, as decisions on tax-advantaged or government backed savings and investment products would be the responsibility of an independent Scottish Government. What is certain is that a number of popular savings and investment products used by consumers across the UK, including Scotland, would not be available to Scottish residents in their current form under independence.

Competition

4.57 The UK Government is committed to fostering a strong, competitive financial sector. This is necessary to ensure that the UK economy can benefit from banking products and services at efficient prices. Effective competition is also a spur to innovation and economic growth, and can lead to better quality and service for consumers. There are challenges in the UK financial services market at present, particularly in the market for personal current accounts (PCAs). The Government is taking a range of steps to address these, in coordination with the new regulators established under the Financial Services Act 2012, and in particular the FCA – which has a specific objective to promote competition in the interests of consumers of financial services.

4.58 The fragmentation of the domestic UK market that would result if Scotland became independent would be likely to weaken competition, and make it more difficult for the regulatory authorities to address barriers to competition when they arise.

Box 4E: Motor insurance

The UK has more than double the number of motor insurance providers than any other EU Member State and is, as a result, considered to have one of the least concentrated markets.[1]

In some respects, Ireland is a close comparator for an independent Scottish state, having a similar population size and disposable income per capita to Scotland.[2] Using the motor insurance market as a comparator, a difference can be seen between the smaller Irish market and the larger UK market.

The Irish motor insurance market is heavily concentrated, with the five largest operators having a total market share of 89 per cent in 2008.[3] The Irish motor insurance sector has seen sustained increase in profitability; however the Consumer Association of Ireland has maintained that premiums have not decreased in line with the large profits, and that market entry has also not increased.[4]

However, a Europe Economics report states that the UK motor insurance sector relied on investment returns after not making any underwriting profit in any year except 2001-02.[5] Similarly, the German and Italian sectors are less concentrated and have very tight profit margins, suggesting that in this case, the larger markets may have contributed to a greater level of competition.

The UK continues to face challenges in the competition area, and has structures in place to deal with these. For example, the Office of Fair Trading (OFT) referred the motor insurance industry to the Competition Commission in 2012 to be investigated over possible anti competitive practices. However, the size and depth of the UK market means that there is scope to address these issues. As discussed in this section, if Scotland became independent, the Scottish market would likely be smaller and less efficient, and it would therefore be more difficult for competition authorities to address weaknesses in competition.

1 *Retail Insurance Market study*, MARKT/2008/18/h, Final Report by Europe Economics, page 171.

2 Real adjusted gross disposable income of households per capita is available from Eurostat, epp.eurostat.ec.europa.eu

3 *Retail Insurance Market study,* MARKT/2008/18/h, Final Report by Europe Economics, page 142.

4 *Retail Insurance Market study*, MARKT/2008/18/h, Final Report by Europe Economics, page 144.

5 *Retail Insurance Market study*, MARKT/2008/18/h, Final Report by Europe Economics, page 172.

4.59 As discussed in the first part of this Chapter, one major benefit of the single domestic market in the UK at present is the fact that there are consistent standards of consumer protection throughout. This makes it easier for consumers to choose between products being offered in the UK market. In effect, having consistent standards aids comparability between products, which means that it is easier for consumers to make an informed choice. The benefits of this are made clear in Box 4F, which discusses price comparison websites.

Box 4F: Case Study – price comparison websites

The fragmentation of the single UK market that could be caused by divergence between an independent Scotland and the continuing UK would result in a separate smaller market for Scottish consumers. This effect can be illustrated by looking at price comparison websites (PCW) such as Gocompare.com and Confused.com.

The online price comparison business has grown significantly in recent years, which has, according to a European Commission survey, provided an average saving to consumers of 7.8 per cent across Europe.[1] An Office of Fair Trading (OFT) study into PCW points out that they enable customers to get better deals; are a cost-effective way for suppliers to reach large numbers of consumers; and ultimately encourages greater competition that comes from increased price transparency.[2]

PCWs for financial services and products are usually limited to comparing products that are available in the domestic market and suitable for the consumer to purchase. Currently, the PCWs operate over the whole UK, allowing consumers to choose the best offer for them within the UK market. However, divergence between the regulatory, tax and legal environments of Scotland and the UK that requires separate products for the two markets would make UK-wide comparison more difficult or even impossible. PCWs would need to provide separate services for each marketplace, inevitably reducing the number of products on offer, which may impact on the savings that such PCWs could deliver to consumers.[3]

1 *Consumer market study on the functioning of e-commerce and Internet marketing and selling techniques in the retail of goods*, Civic Consulting Survey, Final Report: Part 1, commissioned by Executive Agency for Health and Consumers, 2011.

2 *Price comparison websites: trust, choice and consumer empowerment in online markets*, OFT report, 2012, available at www.oft.gov.uk

3 This point has been made by the British Insurance Brokers Association at their Annual Scottish Conference in November 2012, accounts of which is available at www.postonline.co.uk/ (*BIBA: Scottish Independence could pose problems for cross-border trade*, 20 November 2012)

Costs to consumers

4.60 As discussed in Chapter 2, the existing UK environment minimises costs for financial services firms. These costs would be likely to increase should Scotland become this independent. A number of impacts could drive this, such as higher funding costs, larger proportional costs from the creation of two smaller markets and the extra practical costs of operating in two markets.

4.61 In general, additional costs to industry are passed on to consumers. The extent to which costs are passed on to consumers is largely dictated by the degree of competition in the sector. For example, increased costs in areas of low competition are expected to be passed on and result in prices of products going up. Alternatively, increased costs in areas of high competition tend to reduce product quality, rather than lead to higher prices.[22]

22 See *Bringing Profitability back from the brink of extinction, a report on the UK retail motor insurance market*, Ernst & Young, 2011

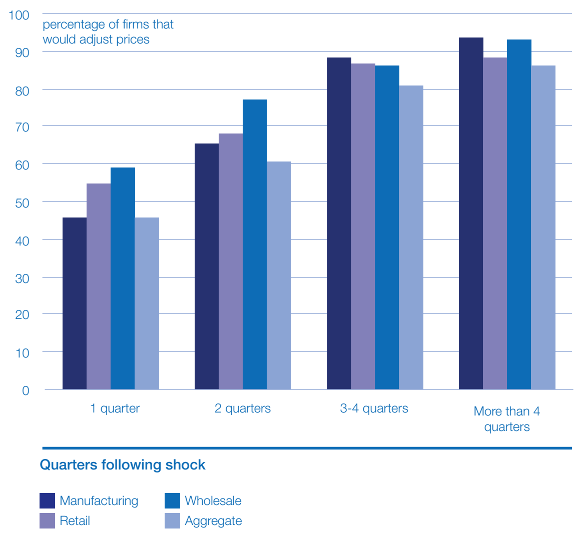
Box 4G: How are higher costs to industry passed through to consumers?

It is a widely accepted position that increased costs to industry can be passed on to the price of products and services sold to its consumers. The mechanism that would lead to higher costs resulting in higher prices is the firm's price setting decision.

The simplest models of price setting behaviour involve firms adding a mark up to the costs they face, such as labour costs, raw materials and financial costs. The first and the last of these are likely to be the most relevant for financial services. A firm also considers the market conditions for the product or service they are providing. This includes the demand for the product or service and the price set by competitors (in turn depending on the structure of the market the firm is in). Recent Bank of England analysis has, however, found that it is these costs that are the most important determinant of price increases in the UK.[1]

In the financial services market, where a relatively large number of firms offer differentiated products, economic theory suggests firms will set prices to maximise profits, i.e. equal to the cost of producing the service. When there is an increase in costs, for example a rise in funding costs, the firm will only find it profitable to supply the same service to the market at a higher price, effectively "passing on" the rise in costs it is facing to the consumer of the service. The firm may choose to do this immediately by charging more for its service(s) or the firm may choose to absorb some of the rise in costs to maintain the prices faced by the consumer. The latter causes the firm's margin (roughly speaking, the difference between its costs and revenues) to be squeezed and this can usually only continue for a temporary period. In the event of a significant increase in costs, the results of the Bank of England analysis (see Chart below[2]) shows that such events, in most cases, result in the cost being past on via a change in the price of a product or service.

Chart 9: Percentage of firms changing price in reaction to significant increase in costs



[1] See *New insights into price-setting behaviour in the United Kingdom*, Greenslade and Parker, Bank of England, July 2010.

[2] From *New insights into price-setting behaviour in the United Kingdom*, Greenslade and Parker, Bank of England, July 2010.

4.62 The pass through of costs is discussed further in the two following case studies on costs of mortgage borrowing and costs of life insurance.

Box 4H: Cost of mortgage borrowing

As discussed in Box 1D, Scottish independence would be likely to lead to an increase in funding costs for mortgage lenders. It is likely that these costs could be passed on to consumers, as lenders' funding costs are one consideration in the setting of mortgage rates.

The pricing of mortgages is not just simply determined by the Bank of England base rate. There are a number of core features for all mortgage rate setting:

- the funding costs for firms;
- the losses firms expect on their loans;
- the cost of capital; and
- the operational costs.

The pricing of mortgage rates is usually based on an average of retail and wholesale funding costs – known as the "fund transfer price". As discussed in Box 1D, there are a number of factors that can affect the cost of funding for mortgage lenders that could increase as a result of Scottish independence. These higher costs would feed through to the fund transfer price and therefore set a higher base price for mortgage rates to be based upon.

If, in the event of independence, any or some of the above factors result in mortgage lenders, particularly those domiciled in Scotland, facing higher costs, these could feed through and lead to higher mortgage rates for customers.

Even a small increase in costs could lead to a significant impact. To illustrate, if Scottish independence resulted in there being a one per cent rise in effective mortgage rates it would cost the average Scottish household with a 75 per cent mortgage around £1,300 in increased payments in the first year.[1] For Scottish households with a 90 per cent mortgage, a one per cent rise in rates would be around £1,590 increase in payments in the first year.[2] In total, this would be around £1 billion a year in increased interest payments for all Scottish households.[3]

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1 The Scottish average house price according to ONS is £177,000. An assumed 75 % mortgage means the household would owe little over £130,000. One per cent of this gives the estimate of £1,300.

2 An assumed 90 per cent mortgage on the average Scottish house price means the household would owe around £159,300. A one per cent rise on this would equal £1,593 in the first year.

3 Council of Mortgage Lenders (CML) data for lending flows in Scotland show that 9.4 per cent of total mortgage lending has occurred in Scotland. The total stock of UK mortgage debt is £1.2 trillion and assuming that a similar proportion of the stock of debt belongs to Scottish households, total Scottish mortgage debt is around £100 billion. £1 billion equals one per cent of the stock.

Box 4I: Case Study: Life insurance

Life insurance products are designed to offer cash payment in the event of the policy holder dying before the end of their policy. This money can then be used to ease the financial worries for loved ones, for example paying off a mortgage or providing a cash lump sum. They are long term products that also provide policy holders with a savings and investment opportunity.

There are two broad types of life insurance: term and cash value policies. Term insurance provides basic death protection – if the insured dies during the policy period the beneficiaries receive the amount of coverage purchased. These are very simple products and it is largely a price driven market. Cash value policies bundle death protection and savings accumulation. Individuals are purchasing death protection and saving money with the insurance company at the same time. The saving accumulated is the cash value.

UK cash value life insurance policies are presently offered on a UK-wide basis, providing another form of tax-advantaged investment and savings to consumers, and have complex tax rules. The most recent survey on household spending on insurance from the ABI found that a total of 22 per cent of UK households have whole of life insurance policies.[1] The current UK single market means that firms are able to offer consistent products to consumers in Scotland and the rest of the UK.[2] This may not be possible if Scotland became independent, due to the likely divergence in the regulation and tax treatment of life insurance products, which is driven by national policy objectives.

Any creation of a separate market and the need for different products could lead to higher costs for cash value life insurance policy holders. This would be true for a smaller continuing UK and an independent Scotland. Firstly, firms themselves could face higher practical costs from operating in two markets. Some costs would be one-off from the transition from one to two markets with firms establishing the requirements and structures to operate. This would include:

- regulatory costs such as notification to regulators or the application for a licence;
- splitting operational structures such as IT systems; and
- establishing appropriate governance structures and human capital to accommodate operating in two markets (for example, a board of directors, committees, managing director/general manager, appointed actuary, compliance officer, internal audit function, financial control function, investment management function).

For some smaller firms, they would be required to make an active decision on whether and how to provide their products in the two separate markets. For example, an insurer based in Scotland with no physical presence in the rest of the UK would need to decide whether to sell life insurance cross-border under the "freedom of services" or establish a branch under the "freedom of establishment". Establishing a branch reduces tax and fixed cost advantages for firms but would enable stronger marketing opportunities and allow greater support to distributors.

1 *Data Bulletin: Household spending on insurance in 2010*, ABI, May 2012, p.14.

2 Life insurance products are subject to national tax policy and provided with some level of tax concession in connection with the purchase, ownership, or execution of policies. The differences in tax systems and rules between EU Member States is one of the reasons why there is no single market for life insurance.

Box 4I (continued): Case Study: Life insurance

In the medium to longer term, the potential for added costs to firms either side of the border would revolve around the need to adapt and develop products in parallel for the two markets rather than one. The link between certain life insurance products and the regulatory environment of the policy holder means that that the products are subject to policy revision over time. The existence of two governments setting tax and regulatory policy would mean firms would have to have the necessary structures and capacity to react.[3]

Another area that could contribute to the increase in cost of life insurance would be the added costs for firms from hedging any additional risk introduced by Scottish independence. There are three main potential risks that could be introduced depending on the currency and monetary arrangement that were established in an independent Scottish state; foreign exchange risk, interest rate risk and inflation risk. For example, any change in currency would introduce a foreign exchange risk for UK based insurers on Scottish policy holders that did not previously exist.[4] Even an independent Scottish state using sterling may see actuaries requiring more capital to be held against Scottish policies in order to offset the uncertainty risks that tend to exist within monetary unions or currency pegs.[5]

3 *The EU market for consumer long-term retail savings vehicles: Comparative analysis of products, market structure, costs, distribution systems and consumer saving patters*, BME Consulting, November 2007.

4 See *Scotland analysis: currency and monetary policy*, HM Government, April 2013, on added foreign exchange risk.

5 *Counting the cost of Scottish Independence*, Aviva, Nov 2012.

Costs of retail banking

4.63 As discussed throughout this paper, should Scotland become independent, many of the precise impacts of the separation would depend in large part on decisions taken by an independent Scottish Government and the results of negotiations with third parties including the continuing UK. However, it is clear that Scottish independence would not make the function of retail financial services simpler or easier. The Republic of Ireland, as an independent state with close links to the UK, offers a useful comparison to illustrate some of the obstacles that would be introduced by Scottish independence and the potential changes consumers could expect.

4.64 At present, there is a single market for retail banking covering the whole UK, allowing customers to access and move their money throughout the UK with relatively minimal charge when compared to operating cross-border. Scottish independence would introduce layers of difficulty to retail consumers when operating between an independent Scottish state and the UK, normally at a cost.

4.65 One example is to compare personal current accounts in the UK and the Republic of Ireland, particularly with regards to transactions and withdrawing money. Almost everyone has a current account that allows the daily management of personal finances as well as playing an integral role in connecting savers and investors in the economy. There are around 76 million accounts in the UK, with 94 per cent of all UK adults having at least one account.[23] The standard UK account has no regular fee for the account or for using core services, such as cash machines. UK account holders have access to free-to-use ATMs through the LINK network anywhere in the country. The cost charged by LINK to use the cash machine is absorbed by the card provider. Almost 97 per cent of all cash withdrawals within the UK are free of charge.[24]

23 *Overview of the Personal Current Account Market*, Office of Fair Trading, January 2013, p. 27.

24 See www.link.co.uk/Cardholders/Pages/Charging.aspx

4.66 In Ireland, 80 per cent of households have access to a personal current account.[25] Most personal accounts in Ireland, with the exception of Ulster Bank, charge maintenance and transaction fees to their customers. These include charges for ATM usage, with the exact amounts determined by the individual bank. For example, AIB charge a quarterly fee of €4.50 with a €0.20 transaction fee. The Bank of Ireland offer accounts with a charge a €11.40 quarterly fee with no transaction fees or no quarterly fee with €0.28 transaction fee.[26] On top of this, there are annual stamp duties imposed on all cheques and ATM/direct debit cards.[27]

4.67 Consumers face increased costs when using banking services cross-border between the UK and Ireland. Irish debit card holders withdrawing money in another euro area country are charged at the same rate as in Ireland for using an ATM or making a purchase. For non-euro area countries, such as the UK, debit card holders are charged an increased transaction fee every time they use their card to get money from an ATM or to buy something. The exact cost varies by bank, but is normally a combination of a percentage of the transaction amount and a minimum charge per transaction.[28] Banks also charge for converting the transaction into euros.[29]

4.68 Similarly, UK current account holders are charged for using their debit cards in Ireland. Banks charge four main types of fees on transactions outside of the UK:-

- a foreign usage fee that converts local currency to sterling using the exchange rate of the day;
- a cash withdrawal fee that charges customers for using ATMs overseas, typically deducting 2.75 per cent–3 per cent of what is withdrawn;
- in some cases, credit card interest is automatically charged for overseas usage; and
- a flat fee, usually around £2, that is charged for each transaction.[30]

4.69 The specific landscape of retail banking in an independent Scottish state and the ease of operating with the continuing UK are not certain. However, as is shown by the example of the Republic of Ireland, introducing borders and the resulting divergence between the markets could make it more difficult and come at a cost for both firms and consumers. These costs would only increase if an independent Scotland had a different currency from the UK.[31]

[25] See *A review of personal current account charges,* Central Bank of Ireland, 2011, available at www.centralbank.ie

[26] Figures taken from compare.nca.ie/CurrentAccount, and correct as of 04 March 2013.

[27] A charge of €0.50 per annum per cheque, €2.50 per annum per ATM card and debit card, and €5 per annum charge for a joint ATM and direct debit card. See *A guide to Fees and Charges for Personal Accounts,* AIB, July 2012 or www.revenue.ie/en/tax/stamp-duty/leaflets/stamp-duty-financial-cards.html

[28] For a list of account and transaction charges for Irish consumers see compare.nca.ie/CurrentAccount

[29] See www.nca.ie/nca/using-money-abroad

[30] See www.moneyadviceservice.org.uk/en/articles/bank-fees-at-a-glance

[31] *Scotland analysis: currency and monetary policy*, HM Government, April 2013.

Benefits of scale in the UK domestic market

4.70 Consumers benefit from the capacity of the UK as a single market. The UK provides industry with greater opportunity to pool risks and off-set costs and losses. The UK Government is able to work alongside industry to utilise the benefits of scale in the UK wide market in order to provide customers with products that would otherwise not be available. These benefits can be seen in a number of areas such as catastrophe insurance and financial inclusion.

4.71 For example, there have been improvements in financial inclusion throughout the UK through a combination of Government policies and its working with industry. The UK has encouraged financial inclusion through two main approaches:

- the setting up of specific initiatives to try to promote financial inclusion such as the Post Office Card Account;[32] and
- working with banks on a voluntary basis to encourage them to make services available to those who might otherwise by denied access.

Box 4J: Case Study: Pool Re

The UK terrorism reinsurance scheme, Pool Re, is one example of the UK Government working with industry to provide businesses with products that would otherwise be unavailable and benefit from the scale of the single market.

Pool Re was set up in 1993 as a reinsurance scheme whereby insurers can pass on risk and pay a premium for reinsurance cover from Pool Re for losses from terrorism damage to commercial property. The establishment of Pool Re followed a series of Northern Ireland related terrorism incidents in London and elsewhere in England, which caused the reinsurance market for terrorism risk to dry up.[1]

Since 1993, Pool Re has processed claims relating to 12 separate terrorist incidents with payment to claimants in the region of £620 million. These payments have been met entirely within Pool Re's own reserves. It remains the case that the reinsurance market in terrorism cover would not provide cover on the scale required without a Government backed scheme, which is why it continues to exist.

[1] The Reinsurance (Acts of Terrorism) Act provides the statutory basis for Pool Re and so the scheme is therefore tied to primary legislation, plus a retrocession agreements and a number of other agreements with members of Pool Re. The scheme, as is typical for reinsurance cover, requires each insurer to pay losses up to a threshold and claim on their reinsurance from Pool Re when losses exceed this level. Claims on Pool Re are met through accumulated reserves from reinsurance premiums that are collected. In the event that claims from insurers exceed these reserves, Pool Re can draw funds from the UK Government In this event, Pool Re would need to pay back the Government as reserves are accumulated in subsequent years.

[32] It has been considered that Post Office Card Accounts introduced in April 2003 were important in providing basic banking facilities to those most prone to financial exclusion. See *Financial Inclusion: A Topic Report from the Scottish Household Survey*, Scottish Government Social Research, 2007, p. 3.

Box 4J (continued): Case Study: Pool Re

Pool Re presently has an asset base of circa £5 billion available to cover losses. It has been successful in providing terrorism cover for the largest international events held in the UK, including the recent London Olympic Games. Insurance will be available for the forthcoming Commonwealth Games to be held in Glasgow in 2014. Large international events are characterised by heightened risk for terrorist attack which would often lead to higher premiums for policyholders. However, the Pool Re scheme was able to provide cover for the Olympic Games without raising premiums.[2]

Scottish independence would add a number of difficulties to the operation of the Pool Re scheme. Under current arrangements, properties eligible for the scheme must be located in England, Scotland or Wales.[3] The decisions on how the scheme would be affected by Scottish independence would have to be settled by negotiation.

It is possible that if Scotland became independent, Pool Re would continue as a reinsurance scheme for the continuing UK. The overall impact on Scottish consumers would be determined by the actions taken by an independent Scottish Government. One scenario is that the Scottish Government does not invest in a similar scheme as Pool Re for Scottish risks. This would likely lead to there being a lack of adequate market for terrorism cover for relevant Scottish properties.

An independent Scotland could decide to replicate or design a similar scheme to Pool Re for Scottish properties. There would be a question of whether a standalone Scottish scheme would be able to provide the same benefits of cost reduction that comes with the larger risk sharing market provided by the UK as a whole. A standalone Scottish pool would result in a smaller fund pool of reserves for Scottish firms to claim against in the event of a terrorist incident. This has the potential to lead to higher premiums for Scottish properties and would result in a greater contingent liability for the Scottish Government in the event of a severe terrorist incident.

2 *Terror reinsurer has $7 billion behind Olympics,* Reuters, April 2012.

3 See www.poolre.co.uk/Risks.html

Conclusion

4.72 In the current UK market, consumers can choose from a wide range of financial services products on offer, and competition helps to drive down costs. It also allows greater risk diversification in products and services, such as insurance and mortgages, giving firms greater capacity to offset losses therefore reducing the costs to consumers.

4.73 Should Scotland become independent, these factors would inevitably be affected. Impacts on and changes to the financial services sector could have an impact on the choice and cost of financial services and products to consumers, households and businesses.

4.74 Scottish independence could have an impact on households' and businesses' ability to access finance. Access to finance is a function of choice and cost, and these could be affected by independence in a number of ways. The cost of doing business for firms could increase. Any increase in cost is likely to be passed on to consumers. Increased costs could act as a disincentive to firms to operate in Scotland, decreasing choice and the level of competition in the market.

4.75 In the long term, the smaller Scottish market could become less contestable (i.e. more difficult for firms to enter) than the current UK-wide market. The creation of two smaller markets would see firms lose the benefit of scale that are achievable in larger markets, which may also translate in to higher costs. It would also lead to less efficient forms of consumer protection than that seen currently in the UK. There is a real risk that these factors could contribute to an independent Scottish state being seen as a less attractive place to do business, resulting in a less dynamic financial services sector for Scottish households and businesses.

Annex A: Statistical annex

A.1 This statistical annex sets out Treasury analysis of FSA regulatory data, which is referred to in previous chapters. It is also available to download from www.gov.uk as a spreadsheet

	Assets as % of GDP
Banks and Building Societies (whole UK)	492
Banks and Building Societies (UK excluding Scotland)	408
Banks and Building Societies (Scotland)	1254

Banking sector assets relative to GDP in an independent Scottish state

	UK (excluding Scotland) firms	"Scottish" firms
FSA funding	389,850,379	83,154,939
MAS funding	34,946,990	7,144,449
FOS funding	15,298,113	2,803,194

Industry funding of the regulatory regime

	Scottish Firm and Scottish Property	Scottish Firm and Not Scottish Property	Not Scottish Firm and Scottish Property	Not Scottish Firm and Not Scottish Property	Total
Mortgages	38,965	204,645	40,448	618,835	902,893
Pension products	19,075	186,627	44,145	567,310	817,157
ISAs	14,045	110,583	6,868	98,121	229,617

FSA Product Sales Data for Mortgages, stocks and shares ISAs and Pension products excluding missing postcode for the financial year 2011-12

Product Type	Scottish Firm selling to a customer in Scotland	Scottish Firm selling to a customer in the rest of the UK	Firm from the rest of the UK selling to a Scottish Postcode	Firm from the rest of the UK selling to a customer in the rest of the UK
Stakeholder pension	1,341	15,411	4,751	59,618
Section 32 buy out	638	4,009	14	207
Guaranteed income/growth/investment bond	0	0	15	44
With profit endowment	638	5,045	4,317	24,502
Structured capital at risk product	0	0	1,646	14,074
Mortgage endowment	0	0	0	23
Group personal pension	10,027	99,738	14,756	170,442
Other. Use this when product is not one of the above	3,763	50,140	1,359	25,087
Unit Trust/OEIC	2,957	21,649	5,209	77,485
Distribution bond	0	0	650	4,233
Trustee investment bond	28	38	8	124
FSAVC	0	0	0	78
Executive pension	42	45	7	248
Personal pension	1,311	14,784	5,711	82,509
Endowment savings plan	1,022	7,269	628	10,972
Life annuity	2	13	14	469
SSAS	0	0	0	7
Income drawdown	619	5,037	1,591	18,543
Group section 32 buy out	146	5,269	57	2,714
Self Invested Personal Pension	1,957	14,780	1,680	32,921
Group money purchase	42	292	2,964	44,952
Long term care insurance	0	0	27	1,220
Unit linked bond	114	703	2,725	23,069
With profit bond	217	1,863	2,862	11,244
ISA	14,045	110,583	6,868	98,121
Investment Trust	389	1,796	225	3,584
AVC group money purchase	4	96	50	1,279
Pension annuity	1,699	17,285	10,641	122,997
Individual pension transfer	1,215	9,672	1,829	29,375
Pension opt out	32	196	80	951

FSA Product Sales Data for retail investment products excluding missing postcode for the financial year 2011-12

FSCS Class	Total of all 'Scottish' firms	Total of all UK (excluding Scotland) firms
Deposit taking	173,748,538	704,960,218

FSCS coverage in Scotland and the rest of the UK in the deposit taking class

FSCS Class	All UK firms as % of whole UK GDP	Scottish firms as % of Scottish GDP	UK (excluding Scotland) firms as % of UK (excluding Scotland) GDP
Deposit taking	58	116	52

Contingent liability for the state arising from the FSCS

FSCS Class	Tariff measure of class	Total all firms in class	Total of all 'Scottish' firms	Total of all UK (excluding Scotland) firms	Share of all 'Scottish' firms
Deposit taking	Protected Deposits	878,708,756	173,748,538	704,960,218	19.80%
General Insurance Provision	Relevant Net Premium Income	40,763,697	1,416,609	39,347,088	3.50%
Life & Pensions Provision	Relevant Net Premium Income	72,263,448	18,069,317	54,194,131	25.00%
Fund Management	Annual Eligible Income	4,734,015	347,560	4,386,455	7.30%
Home Finance Provision	FSA periodic fees	9,434	2,907	6,527	30.80%
General Insurance Intermediation	Annual Eligible Income	8,759,405	382,687	8,376,718	4.40%
Life & Pensions Intermediation	Annual Eligible Income	2,876,645	254,284	2,622,361	8.80%
Investment Intermediation	Annual Eligible Income	3,801,064	234,777	3,566,287	6.20%
Home Finance Intermediation	Annual Eligible Income	3,081,362	181,219	2,900,142	5.90%

		As % of GDP		
FSCS Class	Tariff measure of class	All UK firms as % of whole UK GDP	Scottish firms as % of Scotland's GDP	rUK firms as % of rUK GDP
Deposit taking	Protected Deposits	57.97	115.58	51.63
General Insurance Provision	Relevant Net Premium Income	2.69	0.94	2.88
Life & Pensions Provision	Relevant Net Premium Income	4.77	12.02	3.97
Fund Management	Annual Eligible Income	0.31	0.23	0.32
Home Finance Provision	FSA periodic fees	0.00	0.00	0.00
General Insurance Intermediation	Annual Eligible Income	0.58	0.25	0.61
Life & Pensions Intermediation	Annual Eligible Income	0.19	0.17	0.19
Investment Intermediation	Annual Eligible Income	0.25	0.16	0.26
Home Finance Intermediation	Annual Eligible Income	0.20	0.12	0.21

FSCS Reported levy base (£000s, 31 Dec 2011) [Source – FSA 9 October 2012]

Annex B: Structures that an independent Scotland would require

Regulation

B.1 As discussed in Chapter 2, Scotland would be required to establish its own framework for the regulation of financial services. A number of models have been suggested for an independent Scotland, including most recently a proposal from Scottish Government's Fiscal Commission Working Group that prudential regulation would be carried out "on a consistent basis across the sterling zone" (i.e. across the UK and an independent Scotland), whereas conduct regulation would be subject to a different set of standards imposed by Scotland. This analysis does consider those proposals in detail.

B.2 If Scotland were to become independent, it might wish to "adopt" the existing body of UK law in this area. Thereafter, Scotland would be responsible for ensuring this legislation was compatible, and remained compatible, with EU law. Scotland would have a range of specific responsibilities under EU law, which could not be "shared" with the UK Government.

B.3 Scotland would be required to establish and maintain a compensation scheme for depositors and investors of banks and investment firms which could no longer meet their obligations. It would be Scotland's responsibility to ensure that the schemes were adequately funded, by levying the Scottish financial services industry and, where appropriate, providing liquidity assistance to the scheme. The schemes maintained by Scotland would need to provide compensation to the depositors/investors of Scottish firms in other EEA states (including depositors in the rest of the UK). EU law proceeds on a 'home state' basis for compensation purposes. It would be a breach of EU law for Scotland to discriminate in the provision of compensation under the relevant Directives between depositors of Scottish firms in Scotland and depositors in other parts of the EU. The Scottish deposit guarantee scheme would face some significant challenges, which are discussed in more detail in Chapter 4.

B.4 EU law on the insolvency of banks makes it clear that it is the responsibility of the home state to deal with the insolvency of the bank, including dealing with the overseas branches of the bank. This "home state deals with failure" principle is being extended to resolution planning and to resolution under the Recovery and Resolution Directive which was published by the Commission in June 2012.

B.5 There is no EU law that applies directly to the provision of liquidity assistance by a central bank as part of the central bank's normal operations. So long as the assistance is not underwritten by the state, and is within the normally accepted bounds of central bank actions, such assistance is not generally regarded as state aid. However, liquidity assistance provided by the Bank of England to Scottish firms where the funds were provided by the Scottish state or the Bank was indemnified by the Scottish state are likely to be treated as state aid – because the ultimate financial risk is borne by the Scottish state rather than the central bank. Such aid would need prior approval from the European Commission. Even if approval is given, it is likely to be given subject to conditions including conditions relating to restructuring of and divestments by the firm in question.

B.6 In summary, EU Member States are responsible for putting in place a regulatory regime that fulfils the state's obligations. They are also liable for infraction proceedings if the regulator behaves in a way which is contrary to European rules. For example, if the European Commission decided that a requirement imposed by the Scottish regulators discriminated against incoming EU firms, any penalties would be imposed on Scotland, even if the Scottish Government were contracting in the services of the UK regulators.

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Annex D: Glossary

Actuary – A financial professional trained in the application of mathematics and statistics to issues relating to general insurance and life assurance. Some are employed by companies to calculate insurance risk and premiums.

Assets – Any object, tangible or intangible, that is of value to its owner. In most cases it is either cash or can be turned into cash.

Banking failure – the situation in which a bank is unable to meet its credit obligations. This may occur when too many of a bank's loans default or when a bank has too few accounts providing it with cash flow.

Capital – Money or assets put to economic use.

Central Bank – The most common kind of monetary authority within an economy, it is responsible for the implementation of monetary policy. Central banks are often also given remits over financial stability.

Competent Authority – Person or organisation that has the legally delegated or invested authority, capacity, or power to perform a designated function.

Contingent liability – A potential obligation that may be incurred depending on the outcome of an uncertain future event or events.

Cost effective – Achieving a goal with the minimum of expenditure or with an expenditure that makes the achievement viable in commercial terms.

Credit Default Swaps (CDS) – A swap designed to transfer the credit exposure of fixed income products between parties. One party in the swap is a lender and faces credit risk from a third party, and the counterparty in the swap agrees to insure the risk in exchange for regular periodic payments up until the maturity date of a contract. CDS data is used to monitor how the market views credit risk of an entity.

Credit rating – An evaluation of the relative credit risk of a country or company.

Credit risk – The risk that a borrower will default on debt repayments.

Critical mass – A size, number, or amount large enough to produce a particular result.

Currency peg – A fixed exchange rate regime. The value of the exchange rate is fixed/pegged against a foreign currency or basket of currencies.

Defined benefit pension scheme – A pension scheme in which members pay contributions to receive a defined benefit (a given proportion of their salary) at retirement.

Deposit guarantee scheme – A deposit insurance to protect depositors, in full or in part, from losses caused by a bank's inability to pay its debts when due.

Distributors – the intermediaries that make a product or service available for use by a consumer or business user.

Economies of scale – The increase in efficiency of production as the number of goods being produced increases. Typically a company that achieves economies of scale lowers the average cost per unit through increased production since fixed costs are shared over an increased number of goods.

Euro area – Collective term for the 17 states that have formally adopted the euro as their common currency and the European Central Bank as their central bank: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

Exchange rate – The price at which one currency can be converted into another.

Financial regulation – Laws and rules that govern the financial sector. Covers both micro-prudential regulation (that aims to ensure the soundness of individual financial institutions) and macro-prudential regulation (that focuses on the stability of the financial system as a whole against systemic risk).

Financial sector – The sector of the economy that provides financial services to the rest of the economy. Includes commercial banks and other financial institutions (e.g. insurance companies, investment funds).

Financial stability framework – The set of institutions and policies that seek to preserve financial stability. This includes a crisis prevention arm (covers mostly financial regulation) and a crisis management arm (in particular the role of lender of last resort to the financial sector).

Fiscal authority – A government institution that oversees fiscal policy. The institution will therefore have the power to raise taxes and engage in government spending.

Fiscal policy – Government economic policy in which changes in taxation, spending on welfare payments, public services and capital, and government borrowing are used to influence the economy.

Fixed costs – The expenses of a business that does not change with an increase or decrease in the amounts of services or goods produced.

Foreign direct investment (FDI) – External investment in assets or businesses.

Foreign exchange risk – The risk of an investment's value changing due to changes in currency exchange rates.

Formal currency union – Where two or more states agree to formally share a single currency, with the attached common institutions and policy setting.

Freedom of establishment – One of two "fundamental freedoms" of the EU Internal Market. It enables a person or company to carry on economic activity in a stable and continuous way in one or more Member States.

Freedom of Service – One of two “fundamental freedoms” of the EU Internal Market. It enables a person or company providing services in one Member State to offer services in another Member State, without having to be established.

Funding costs – The cost to banks of borrowing in the principal money markets, which determines their rates of interest when lending to their customers.

Gross Domestic Product (GDP) – A measure of the total flow of goods and services produced by an economy – known as ‘output’ – over a specified time period, normally a year. It is equal to GVA as basic prices plus taxes (less subsidies) on products.

Gross Value Added (GVA) – A measure of the total flow of goods and services produced by an economy – known as ‘output’ – over a specified time period, normally a year. It is a measure of GDP in basic prices, before taking account of taxes and subsidies on products.

Hedging – Taking an investment position intended to offset potential losses or gains that may be incurred by associated investment

Industrial cluster – A geographical concentration of interconnected companies with close supply links, specialist suppliers, service providers, and related industries and institutions.

Inflation – The rate at which the prices are rising within an economy (generally measured as annual growth rate in the CPI)

Inflation risk – The possibility that the value of assets or income will decrease as inflation reduces the relative value of a currency.

Interest rate – The price at which money is lent. Traditionally, this is the key variable through which monetary policy is transmitted.

Interest rate risk – The risk that an investment’s value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship.

Lender of last resort – An institution willing to extend credit when no other institution would.

Liquidity – A measure of how readily an asset, or a portfolio of assets, can be bought or sold in the market without affecting its price. Liquidity in a market is characterised by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Macroeconomic framework – The framework within which macroeconomic policy is set. This includes both the policies and the institutions the government uses to influence the economy. It comprises monetary policy, fiscal policy and financial stability.

Macroeconomic stability – A situation where key macroeconomic variables are stable and free from unexpected shocks or are able to respond quickly and effectively to such shocks.

Macroeconomy – A description of the economy taken as a whole.

Monetary authority – The institution responsible for the implementation of monetary policy. The most common form of monetary authority is the central bank.

Monetary policy – Process through which the monetary authority controls the supply of money in order to reach its policy objectives (which often include objectives for price stability and wider objectives for economic stability and growth). The main policy instrument is generally a target interest rate.

Monetisation – The scale of Treasury bills to banks by a sovereign government to finance a budgetary deficit

Moral hazard – 'Moral hazard' arises when a party has incentives to alter its behaviour because it is not fully exposed to the consequences of its actions, which will also affect another party.

Operational costs – The expenses associated with administering a business on a day to day basis. Operational costs include both fixed costs and variable costs.

Passporting – The right of a company registered in the European Economic Area (EEA) to carry on business within another EEA state under the Single Market Directive.

Policyholder – Someone that holds an insurance contract or policy.

Productivity – The relationship between the output of goods and services and the inputs of resources used to produce them. Higher productivity enables higher output from the same quantity of inputs.

Recapitalisation – The process of changing the balance of debt and equity financing of a company without changing the total amount of capital. Recapitalisation is often required as part of reorganisation of a company under bankruptcy legislation.

Risk – The probability that an actual return on an investment will be lower than the expected return.

Risk pooling – The sharing or reducing of risks that could not be absorbed by a single party. Risk pooling reduces a person or firm's exposure to financial loss by spreading the risk among many members or companies.

Shock – An event which has an impact on an economy, in either a positive or negative way. Shocks may come from a source inside or outside the economy.

Single Market – A market consisting of a number of nations in which goods, capital, and currencies can move freely across borders without tariffs or restrictions.

Solvency – The financial state of a person or company that is able to pay all debts as they fall due.

Systemic risk – The risk of failure in a whole system.

Transaction costs – The costs associated with buying and selling, particularly in financial transactions. An example is the fee charged for foreign exchange trade between sterling and euro transactions.

Transition Costs – One-off costs to the economy of moving to a new policy framework.

Unemployment – The proportion of the working age population actively seeking work but unable to obtain a suitable job.

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