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SCOTTISH INDEPENDENCE AND FINANCIAL SERVICES – AN INDUSTRY OBSERVER'S PERSPECTIVE

Scottish Financial Enterprise is the representative body for Scotland's financial services industry. It is a private organisation, funded by its member companies. It has followed debates about Scotland's constitutional position ever since its inception in 1987, which says something about how long these debates have been going on. But at the time of writing, in the autumn of 2012, the debate has focused more acutely than ever before, arguably, on independence and its practical implications.

SFE is not a political body and it strives very hard to maintain its impartiality in party political arguments. However, that does not mean we are disinterested or uninterested in matters of public policy that affect our industry and the questions surrounding independence do so, in manifold ways.

In this paper, I set out an industry perspective on some of the questions that arise, naturally and ineluctably, about how the Scottish financial services industry could be affected by independence. Throughout our examination of these issues, we have been followers of David Hume. He famously observed that 'the wise man proportions his belief to the evidence'. We are focused as much as we can be on facts and evidence that can be discovered and ascertained now. It is a striking feature of much of the debate about independence that it is led by assertions, not facts. This is true on both sides: an assertion by those opposed to independence that Scotland could not use electricity generated by nuclear power after independence and that costs to business would therefore rise, for example, is to take a policy of the party most prominently in support of independence (the Scottish National Party) and transpose it unchanged into a hypothetical independent Scotland. The same can be said about assertions made by those who favour independence that Scotland, after independence, will have a better tax system. We don't know what sort of tax system an independent Scotland would have, just as we don't know what decisions would be taken on energy matters.

In fact, we cannot at this stage know all that much about the circumstances that will prevail after independence. A lot will depend on negotiations with the rest of the UK, the EU and perhaps with other supranational authorities, since they will determine many important parameters for policy makers and legislators, such as the terms of EU membership and the basis of the public finances. We also cannot know now what government will be formed in an independent Scotland, nor the electoral system under which it will be elected.

The pro-independence side of the argument, chiefly in the shape of the Scottish Government, has promised to publish its ideas about what could happen in terms of macroeconomics some time this year. It has set up a sub group of its Council of Economic Advisers to create a 'fiscal and macro economic framework for [an independent] Scotland'. But this can only be one possible blueprint for what might happen and it must be subject to agreement with others and, if it came to it, debate and approval from an independent Scottish legislature. So it will be, necessarily, a set of suggestions rather than a clear indication of what will happen.

This is a very significant feature of the debate and the political process as it is unfolding at the time of writing. The referendum, if it happens, will not be on the basis of a prospectus agreed with other interested parties including, most notably in this context, the rest of the UK.

The process of working out how an independent Scotland would actually work and obtaining democratic legitimacy for that can only begin once the decision to become independent has been taken.

SFE has for many months been seeking as much information as we muster on the 5 key questions about independence that seem most relevant to our industry. These are: what currency could be used? Under what terms could Scotland be a member of the EU? What will be the effects of independence on what is currently a wholly single market for financial services in the UK, as it is currently constituted? How long would a transition to independence take and how would the process be managed? And, what would be the requirements for financial regulation, on the working assumption that Scotland, once independent, would be a member state of the EU?

The rest of this paper will concentrate on the currency question. Before moving to that, I should briefly set out our thinking on the other four questions.

EU membership

This is, at the time of writing, a moving picture. The pro-independence argument has for some time rested on the premise that Scotland is already part of the EU, as part of the UK, and that it will therefore 'inherit' EU membership and, crucially, the terms of membership accumulated by the UK in recent years. These terms most notably include the opt outs from the requirements to join the Euro and the Schengen area. This argument is challenged by others, usually but not always opposed to independence, on the basis that Scotland would be choosing to secede from the UK and would therefore become a new state and have to apply for membership, in broadly the same way as, say, Montenegro. All seem agreed that the final decision will be political and will rest with the Council of Ministers. We have been pressing Ministers in London and Edinburgh to secure clarity on this issue before the referendum takes place, on the basis that we are neutral on the question of independence and therefore have no predisposition to favour one interpretation over the other. But both cannot be right; and it is important that we know before the referendum which interpretation is right, if we want to understand the implications of the decision facing the voters. Failing that, it would assist commercial and probably many other kinds of interests to be clear that we cannot actually know the answer to this question beforehand, so that any consequent uncertainties can be assessed and incorporated in planning decisions.

Financial regulation

It seems to us that one of the obligations of an EU member state, implicitly under the regulatory framework if not explicitly written down in the Treaties, is to have a 'competent authority' to regulate financial services. It has been argued by the pro-independence side of the argument that the regulator for the rest of the UK could also cover Scotland, even after independence, but we think this is potentially problematic, for 4 main reasons:

- the regulatory framework presupposes that each member state will have a regulator and there is no provision for sharing one between member states and no precedent for doing so;
- there is no reason to think the Commission or other member states would allow Scotland to carry on without a regulator of its own, when other member states all have to have one and to bear the costs of doing so;

there is no obvious benefit to the rest of the UK in bearing the risks and liabilities of regulating the industry of another member state, so their co-operation cannot be assumed ; and

it seems unlikely that the Parliament in a newly independent Scotland would want to demit a function of government as important as financial regulation to the legislature of another country, or otherwise compromise its freedom to act within the constraints of EU membership, even if that could be done under the EU Treaties.

As noted above, we cannot know what would be decided in an independent Scotland. But the facts we can ascertain now about the regulatory framework suggest it would be difficult to negotiate some sort of unique arrangement for Scotland (and, by extension, the rest of the UK), when Scotland is one of the EU's leading financial centres and London is the largest financial centre in the world.

Single UK market for financial services

There are three main requirements for a wholly single market in financial services - a single tax system, a single currency and a single regulatory jurisdiction. If Scotland continued to use sterling, then the currency element would be maintained. A main economic argument made in favour of independence is that it would give Scotland the opportunity to create a different and better tax system than the rest of the UK. So some divergence in taxation policies seems likely, if not certain. And, as noted above, the creation of a distinct regulatory jurisdiction seems to be a requirement of EU membership. It would theoretically be possible for an independent Scotland to seek complete harmony of taxation and regulation with the rest of the UK, in order to maintain the single market for financial services, but nobody is suggesting that; and it is hard to envisage the financial services tail wagging the public policy dog in this way. So there is more work to be done to assess the changes that independence would bring for companies providing services to customers in other parts of the UK, from Scotland. It is worth noting that Scotland is, in itself, a relatively small market; most providers of financial services in Scotland serve the market that is the UK as a whole and, in some cases, 90% or more of their customers are outside Scotland.

Transition

Little is known about how long it would take for negotiations with the remainder of the UK and with the EU, after a vote in favour of independence, to give a clear picture of the parameters within which an independent Scotland would necessarily operate. Matters as important as the division of the national debt, the terms of a Scottish membership of the EU and Scotland's currency arrangements can only be resolved during this process, not before. Estimates vary: those who support independence suggest it could all be concluded within a couple of years. Others say it could take much longer. We simply don't know. It is not apparent at the time of writing how further reliable factual information about the timetable and nature of a transition to independence could be obtained. Keynes's observation seems worth keeping in mind:

"It is not sufficient that the state of affairs that we seek to promote should be better than the state of affairs that preceded it; it must be sufficiently better to make up for the evils of the transition."

Perhaps balanced, lest we become too prosaic in our thinking by our focus on facts and evidence, with Browning's more aspirational line:

"Ah, but a man's reach should exceed his grasp, or what's a heaven for?".

Currency matters

We have not sought clarification of how a currency would be managed in an independent Scotland only from the Scottish government. This is mainly because their declared policy preference, for Scotland to use sterling even once independent, is not something they could realise at their own hand, even if in government after independence is achieved. The full-blooded support of the rest of the UK for a shared currency would be required, unless sterling was used in Scotland on a 'dollarised' basis - that is, it was used simply as a means of exchange, with no engagement in the monetary policy or currency management associated with the currency. This is the basis on which a country like Ecuador uses the US dollar. The central bank in such a situation plays a role quite different from that of a country issuing its own currency, focused more on managing liquidity.

Would an independent Scotland need its own central bank?

It is also worth noting in passing that under article 130 of the Treaty on the Functioning of the European Union, each Member State must have in place an institution that is capable of participating in the European System of Central Banks (ESCB) and its national law must ensure the independence of such an institution. The institution must have, "institutional, personal and financial independence."

Participation in the ESCB comes with certain rights and obligations depending on whether the Member State uses the Euro. Obligations include making a capital contribution through its national central bank to the ESCB. If one considers that an independent Scotland would have to meet accession criteria (and this is disputed as noted above), one of these criteria is the, "ability to take on obligations of membership, including adherence to the aims of political, economic and monetary union." So any prospective member must have the requisite institution in place to fulfil its Treaty obligations under the ESCB. For example, the Croatia Accession Partnership Agreement, Chapter 17 required Croatia to, "align the legal framework in order to ensure full central bank independence, and to allow for the full integration of its central bank into the European System of Central Banks."

Detailed accession requirements are specific to negotiation between the European Commission and the country wishing to join the EU and, ultimately, approval by all the other member states. However, the Treaty on the Functioning of the European Union is drafted in such a way that it presumes that every Member State (Eurozone, future Eurozone, and Member States with a Euro derogation) has a central bank. So it is worth exploring whether Scotland, once independent, would need to have its own central bank, as opposed to one shared with the rest of the UK, in order to meet its obligations as a member of the EU. The question arises not because there is in the letter of the Treaty a direct requirement that each member state must have its own central bank, nor because of an explicit prohibition on sharing one, but because the existence of a central bank in each member state is the expectation on which the whole system rests.

As with other matters relating to EU membership, it might be theoretically possible to negotiate some special arrangement, though that seems unlikely to be a straightforward process and might require amendments to the Treaty more extensive than those already necessary to accommodate a new member state, on matters such as the number of MEPs.

Other currency questions

We have raised a number of questions relating to the currency with political authorities in London and Edinburgh. These include:

If an independent Scotland wished to continue to use sterling, what would the UK authorities need to do to facilitate this?

As the First Minister has pointed out in media interviews, one answer to this question is ‘not very much’, as sterling is a convertible currency and it would be open to any country to use it as a means of exchange, provided the country concerned sought no involvement in monetary policy or the management of the currency. While I am not aware of any discussion of these issues with UK authorities, it seems likely that some assessment would be needed of the risks to currency stability of having an economy of Scotland’s size using the currency on that ‘dollarised’ basis. If, however, attempts were made to include Scotland in the currency’s policy frameworks, the UK authorities would need to be willing to contemplate such a step (and perhaps to engage in a debate about Scotland’s proprietary rights over the currency, if any were claimed).

Could the management of the currency take any account of Scottish circumstances, particularly in the event that its economic trajectory diverges from the rest of the UK? Are there examples from elsewhere of monetary union without fiscal union?

Professor McCrone deals with this question more expertly than I could in his paper associated with this one, ‘The Scope for Economic Policy after Independence’. As he notes, it has been suggested that there could be a Scottish representation of some kind on the Monetary Policy Committee, though that would entail a wider reappraisal of how geographies are represented on what is currently a unitary body for the whole UK, with no regional remits. The most striking example of a monetary union without a fiscal union is the Eurozone and, at the time of writing, radical changes are under discussion to deal with what seem to be fundamental problems. Those who support independence for Scotland have been clear that fiscal freedom is a necessary part of their proposal, even if some shared approach to monetary policy can be contemplated. At the time of writing, we await the Scottish Government’s proposals for a currency management framework for sterling with more than one line of democratic accountability and, in due course, responses to that. Both sides of any arrangement for sharing the management of the currency would wish to be sure that their respective taxpayers were not exposed to risks arising from the fiscal or other decisions taken by the ‘other side’.

In the event that an independent Scotland continues to use sterling, could the monetary authorities be accountable in any way to a Scottish parliament?

It is possible to envisage this, along the lines of a 'mini ECB', with accountability to more than one central bank at national level ie to a Scottish one (independent of a Scottish Parliament, to meet EU obligations) and one for the rest of the UK. But the question immediately arises, again, of whether Scotland would need a central bank of its own, even in this sort of sterling zone, to meet its EU Treaty obligations. This is likely to be covered in the Scottish Government's proposals on a macroeconomic framework.

Could the UK provide lender of last resort facilities if it was not also the prudential regulator?

The concept of the lender of last resort is open to various interpretations. To be clear, I am speaking here of the lending of money at relatively high, if not penal, rates to deal with short term liquidity needs in otherwise solvent banks. I am not talking about 'bail outs', where public money is deployed to deal with deeper problems. Again, one might look for guidance on this question to the eurozone, where this is, at the time of writing, a subject for debate as proposals emerge for a European Banking Union. These two issues – liquidity support and prudential regulation - are inextricably linked, as the role of the European Central Bank in the emerging Banking Union proposals confirms. The reforms to the UK's financial regulatory systems, with prudential regulation and financial stability coming together at the Bank of England, are also relevant. It seems to go against current orthodoxy to attempt a separation and it is not clear, as matters stand, who would benefit from doing so.

Could the UK Financial Services Compensation Scheme continue to guarantee deposits in Scottish banks?

Again, we have an example being worked out in real time in the Eurozone. At the time of writing, the European Commission has worked up a proposal for an EDGAR (European Deposit Guarantee and Resolution Fund) to underpin the Banking Union. It is reported that this proposal was withdrawn at the very last minute as it would essentially require German taxpayers to underwrite deposits in the banks of other countries and Germany objected to this. As far as we know, little work has been done on whether or how the FSCS could continue to cover Scottish depositors or savers or, indeed, how or whether a Scottish scheme could cover non-Scottish depositors or savers. But it seems worthwhile to keep a close eye on how the EU resolves these matters.

Conclusion

As the old Johnny Nash song says, 'there are more questions than answers'. There is a strong appetite for clarity about what independence would mean in practice and this runs strong in the financial services industry, where facts and evidence are always given preference over belief and sentiment. We will continue our search for such facts and evidence but the epistemological dilemma has to be recognised – under the political process that has been constructed, with a referendum first and negotiation about what it actually means only coming later, the proof of the independence pudding can only be in the eating. But it does not have to be this way for every aspect of it; there is much we can discover about the obligations and rights of states within the EU.

The requirement for a financial regulator is only one example of that. If the political will were there, it should be possible to ascertain in advance of a referendum the terms under which Scotland, if independent, would be in the EU. Someone with the requisite status, like a government, could for example canvass opinion among the member states, on the basis of neutral advice about the legal background, and tell us the outcome.

So there is much we can know, and should find out; and much we cannot know, and can only speculate about. Assessing the probability of independence occurring at all, never mind the probabilities surrounding decisions taken thereafter, is not a matter for me but for voters and politicians. So perhaps we should leave the last word to David Hume:

“All that belongs to human understanding, in this deep ignorance and obscurity, is to be sceptical, or at least cautious, and not to admit of any hypothesis whatever, much less of any which is supported by no appearance of probability.”