FEATURE ARTICLE

MOWLEM LECTURE: 31 MARCH
THE ROLE OF THE SCOTTISH FINANCIAL SECTOR

by James Scott CB, LVO, Executive Director, Scottish Financial Enterprise

Following criticism of the Scottish Financial Institutions and their contribution to the Scottish economy, the Fraser of Allander Institute asked Mr James Scott, the Executive Director of Scottish Financial Enterprise to address the inaugural Mowlem Scotland Lecture at the University of Strathclyde Graduate Business School on 31 March 1993.

The lecture, sponsored by the construction company Mowlem Scotland Limited, was devised to provide a new forum for promoting discussion of issues confronting the Scottish economy. In all, seventy leading figures from Scottish business, the institutions, politics and the media were invited to listen to Mr Scott and participate in any subsequent debate.

The following is the text of the Mowlem lecture on, "The role of the Scottish financial sector", given by Mr James Scott.

Every good sermon is built round a text. Let me offer you mine: The quotation opens:

> "The financial sector in Scotland is extremely strong and dominant in the Scottish economy - but what does it put back into Scotland? It is worthless having a respected financial sector that does nothing to help the economy. The vested interests of the financial sector need to be tackled so that the benefits can be accrued by everyone in Scotland, not just a selected minority."

That text did not come from the Bible, although it might remind you of Christ's admonition to the money changers, but from another source of inspiration - the language of politics in Scotland today. It is taken, verbatim, from a speech made barely a month ago by the Shadow Secretary of State for Scotland to an audience of Trade Union leaders in Glasgow. If we remember that Mr Clarke speaks for a political party that enjoys more support in Scotland than any other; and that one must assume that the Shadow Secretary of State accurately articulates views held widely within that party; and that these views may in turn become the foundation of policy, his statement deserves attention and analysis. Before I turn to the exegesis of my text, let me remind you of it.

Verse 1 says:

> "The financial sector in Scotland is **extremely strong** and **dominant** in the Scottish economy."

Indeed it is, and growing stronger and more dominant year by year. Broadly defined, finance and business services account for 15% of Scottish GDP. To put that percentage into perspective, it is over five times that for Agriculture, Forestry and Fishing; three times that for Energy and Water Supply; nearly twice as much as for Construction and for Transport and Communication; and considerably more than for Public Administration and Defence. The only category which exceeds it is all-Manufacturing, with about 21% of GDP; and the only categories which equal it are Distribution, Hotels and Catering; and Education and Health Services.

On another measure - jobs - the financial sector ranks as high. According to the latest figures from the Department of Employment Gazette, it employed 220,000 at end of September 1992, over 11% of jobs in Scotland. Again for perspective, that is nearly eight times as many as in Agriculture, Forestry and Fishing; four times as many as in Energy and Water Supply; more than twice as many as in Construction and as in Transport and Communication. It is about one third short of the total numbers engaged in all Manufacturing sectors lumped together.

One final indicator, and one of importance because it demonstrates that we are not referring here to yet another manifestation of the branch economy and because so much else depends upon it. Of the top 20 Scottish Companies listed in a recent issue of "Business Insider", no fewer than eleven were in the financial sector. One of them, Standard Life, is the biggest mutual insurance company in Europe; another, General Accident, is one of the largest composite insurance companies in Britain.

I said that not only was the financial sector strong: it was growing. For that, I shall not batter you with a long list of figures, simply those for jobs. Five years ago it employed only 165,000, so it has put on in that period more than are currently employed in the whole of our electronics industry, so painfully built up over decades, and nearly as many as are directly employed on-shore in the oil and gas industry.

That is the Scottish perspective, but the Scottish financial sector has not got where it has by confining itself to domestic opportunities. The main service it offers is the management of other people's money. Our latest figures for our life offices and independent fund managers showed that funds under management by Scottish companies now exceed £100 billion, a three-fold increase in the past seven years. That places us fourth in the European Community league, after London, Frankfurt and Paris only. Indeed, it places Edinburgh alone in fourth position with Glasgow in seventh. I should like to be able to tell you that adding the two together takes Scotland ahead of Paris or Frankfurt, but it doesn't yet, although our ambition matches our rate of growth.

As Ian Lang pointed out recently, the funds under management by Scottish companies would be enough to keep him and the Scottish Office spending happily until well into the next Millennium and might see the Conservative Government through until the next Election, although on present spending form, I personally would not bank on it in either case.

Our life offices sell 85 to 90 per cent of their policies outside Scotland. Our Banks operate in England, in the United States and in Italy, Germany and France to name but some. Our fund managers invest money from the USA, Canada, Japan and elsewhere in Stock Markets round the world. We have, in short, an export industry, earning most of its profits from furth of Scotland.

So we can accept the first assertion of my text, and go farther: the financial sector is strong and dominant in Scotland, it is highly significant in England, and it is active overseas. It is an international industry based in and largely headquartered in Scotland, and we do not have too many of these.

I have also to say that it is a well rounded industry, embracing not only the core trading functions of banking, insurance and fund management that I have mentioned, but also the supporting and ancillary services associated with and supplementing them, such as accountants, actuaries, corporate lawyers, global custodians, performance measurers, stockbrokers, private and merchant bankers, financial printers, corporate communicators, designers and PR firms - and so on.

These supporting services cater not only to the financial companies, but to corporate Scotland generally. Without them our chances of retaining, far less winning, prized headquarters functions in any sector of economic activity, including industry, would be slim indeed. The other side of the coin is that it is the presence in Scotland of so many financial company headquarters which nurtures the supporting services. A virtuous circle, in short.

But my text runs on, in verse 2: "But what does it put back into Scotland? It is worthless having a respected financial sector that does nothing to help the economy".

This does require a bit of consideration, for 220,000 jobs and 15 per cent of GDP from the financial sector surely represents some small contribution to Scotland's well being? Nor are they Mickey Mouse jobs either. With so many headquarters here the range of opportunities, the qualifications required and the financial rewards available span the spectrum; indeed, for some, the financial rewards may be pitched a bit high for Mr Clarke's taste. I have, therefore, to guess at the point which is in Mr Clarke's mind.

It is, I suspect, this: the Scottish financial sector is not simply a generator of direct employment and profits, but a catalyst for enterprise and business growth. Mr Clarke may, after some recent and well publicised industrial and commercial failures, believe that Scottish financial institutions are not sufficiently ready to pump money into enterprises which, in his judgement would, with such support, continue in business or even grow and flourish; but which, in exercise of the judgement of the industry's professional managers, would not.

Stop and think what it is that the banks, the life offices and the fund managers do. They collect the money earned by the man in the street on a promise to conserve it carefully and to facilitate its use by its owners; or to make it grow. This is an offer they make to every investor in an interest bearing account - and that is most of us, including those of us who vote for Mr Clarke's party - and to every purchaser of an endowment insurance or pensions policy - and that is most of us, including those of us who vote for Mr Clarke's party. An don't forget the collective pensions schemes managed by Scottish companies amongst others. Almost anyone who hopes for an occupational pension relies on the skill - and integrity - of a fund manager somewhere.

Scottish financial companies are, in short, selling added value to practically every inhabitant of these islands; and we rely on them to deliver just that.

It is a competitive field, and the depositor or investor or policy holder has a bewildering variety of firms offering a bewildering variety of products from which to choose. He does it on price and on performance - which supplier, in his view, seems likely to give him the most added value. So it has to be performance which drives the management of our financial sector companies - performance to satisfy their customers. That applies not only to the man in the street in Scotland or England and Wales, but with even greater force in the struggle for the stewardship of institutional money both at home and in the international market place where competition is even more intense and the purchaser is even more discriminating.

Value is added in a number of ways, and there is no dispute that amongst the most important is investment in manufacturing industry, construction, development and commerce and at home and abroad. Industrial development depends on the availability of money: the financial sector depends in turn on industry to grow money on behalf of its depositors and investors.

So there is mutual dependence. It is equally obvious that the financial sector has every incentive to back a firm which is credit worthy and looks likely to prosper and no incentive whatsoever to pull the plug on a firm which meets these criteria. It is obvious also that Scottish financial firms, particularly our banks, for all their international orientation, will look first to their home market and to their customer firms for investment opportunity, if only because they will know them best. How then do we square the circle with the statement in my text that the financial sector does nothing to help the economy?

For that, I think we have to go on to the reference in Verse 3 to "vested interests" and "selected minority". My contention is that the vested interest is that of every man, woman and child who has placed his or her pennies in the care of a financial sector company: that far from the benefits accruing to "just a selected minority", they accrue instead to the wide constituency I have defined. Indeed, in the case of our independent life offices, the "vested interest" of the 18 million plus policy holders is absolutely direct. Since they have adopted the mutual form of organisation, there is not even a body of shareholders to take a slice of the action. Unusually for any form of company structure in the capitalist world, the life offices in Scotland are owned by their policy holders, to whom all operational profits accrue.

Mr Clarke may be thinking in different terms, of caricature types in silk hats and with cigars stuck in their mouths or of some of the more flamboyant rogues who have graced the public prints in recent years. But these are the managers who failed in their duty to add value for their depositors and investors. They are not at all to be confused with those managers who conclude that a lame duck is beyond redemption and decide against sinking any more of their clients' money in it.

We sometimes come across a related but separate brand of wrong-headedness. This takes voice in the argument that Scottish money managers should back Scottish firms purely on grounds of sentiment or solidarity. From what I have said, I hope you will recognise that this is equally insupportable.

What, I think, critics of the financial sector in this respect seek to do is substitute their own judgement for that of the sector's own managers and, in doing so, they are pursuing objectives of national sentiment, activity and employment without adequate regard to the financial viability which has to be the touchstone for a professional manager of other people's money. There is an unstated premise: that lenders and funders are under some sort of civic obligation to dilute, compromise or ignore the interests of the savers they serve in pursuance of other objectives of domestic growth and of domestic employment.

Now I will not enter into the argument whether there is any validity in the assertion that acting in this way would contribute anything to the increase of Scotland's wealth, but I will say unequivocally that it is no part of the function of a manager who has sold his services to clients on the promise to invest their money with care and to their advantage. Nor is it hard to see both the 220,000 jobs in the industry and its 15 per cent contribution to GDP melting away like snow off a dyke if it was so foolish as to forget that it is judged by those who place their money in it - a judgement that focuses on its stewardship of that money. This is a competitive international business, with no room for kailyard economics, however heartwarming the thought might be for some. The day sentiment or political direction takes over is the day we lost our financial sector's international competitiveness, and with it the sector's huge contribution to the Scottish economy.

The picture is of course clouded by the fact that financial companies do make mistakes and put their money into failing companies. They lose it when such companies go into liquidation, and they lose more when a network of supplier companies follows them down the road to Carey Street. The providers have therefore a fine judgement to make, but it has to be a commercial one: there is no general case for shovelling good money after bad.

My text has, I'm afraid, led me to speak with a little too much Old Testament severity, but I find it worrying when a political party, and a person of importance within it, who might have responsibility for the conduct of our affairs tomorrow, exhibits such total lack of understanding of what the Scottish financial sector does, what it contributes, and whom it serves.

The reality is that the sector is an industry traditional to Scotland in which we have done well and may fairly expect to do better. It has prospered on honesty, innovation and good performance, all honed in successful competition internationally. In proportionate terms, it contributes twice as much to our wealth as the average across the EC and it is one of the limited number of Scottish industries which is expected to benefit significantly from the opportunities opened up by the Single Market.

It is an industry in which every single person in this room is likely to have a stake. Its clients include millions of account holders, policy holders and ordinary investors in Scotland; in the rest of the UK; and world-wide. Some selected minority! Some vested interest!

It provides the funds which every other economic activity in Scotland needs to establish, to continue in business, to grow. It provides these funds on a professional assessment of the likelihood of the money - a scarce resource - being put to good use. In this, it makes mistakes from time to time, but it cannot afford to make too many. And certainly, it cannot afford to make its decisions on any other basis or substitute the judgements of others - least of all politicians of any hue - in this field.

It is, like other industries, affected by recession and where it has taken action to contain its costs in response, it has drawn more than its fair share of public and media criticism. But let me inflict on you one last string of figures to illustrate its resilience, turning again to the Department of Employment Gazette.

In the twelve months to end September, in a period of deep recession in the UK economy and of recession in financial markets in the USA and Japan, it added 17,000 jobs in Scotland. In the same period, the sector in the UK lost 81,000 jobs. In the South East, the sector lost 43,000 jobs. In London, the sector lost 35,000 jobs.

This has to be a factor in the significant - and unprecedented - improvement in Scotland's position relative to other parts of the UK throughout the current downturn in the economy. You would hardly guess at any of this if your daily fare were confined to newspaper articles about redundancies in this or that Bank. You would certainly not guess at any of it if you believe the kind of statement by politicians that I have chosen as my text.