Briefing Paper

SCOTTISH FINANCIAL INSTITUTIONS

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In a financial system as integrated as that of the UK the existence of institutions based outside of London is a source of continuing interest. The absence of controls on the flow of capital and resources suggests that regional institutions wishing to expand may be attracted to the wider markets offered by London. There is a continued concern that the forces for financial agglomeration will exert a decisive pull outweighing the local ties of regionally based institutions.

The issue is critical to the future health and well-being of the Scottish economy since well-functioning regional institutions create employment, induce growth and offer clients a range, completeness and price of financial services that otherwise may be difficult to attain.

The major benefits of Scottish domicile for many institutions are the ease of access to local markets resulting in improved communications, and reduced information costs. Regional institutions have a degree of knowledge of local conditions that can only be acquired by close involvement with customers and companies. The location of regional offices by American banks in Aberdeen, Edinburgh and Glasgow clearly demonstrates the need for local information in finding new opportunities, assessing risk and meeting the needs of existing clients. The locational advantages of insurance companies and portfolio institutions are rather less clear and their present location is generally a consequence of their history. Whatever the cause however, the regional economy benefits through the professional and other employment created at head offices and from indirect effects on employment through a wide range of services such as accountants, lawyers, data processors and printers.

Most significant of the Scottish intermediaries are the three major clearing banks; the Bank of Scotland, The Royal Bank of Scotland and the Clydesdale Bank. In 1984 the three banks employed 25,000 staff in 1,478 branches operating nearly 5m accounts. Some 30% of the banks' lending was to the personal sector whilst other major areas of lending were agriculture, forestry and fishing, manufacturing industry and the financial sector. Surprisingly the differences in manufacturing advances, 14.8% in Scotland compared to 17.8% for all banks operating in the UK were smaller than might have been expected given the reduction in Scotland's heavy industry base. The last ten years have been noteworthy for the more than twelve fold increase in overseas advances indicating the changing nature of banking, together with a fast increase in personal sector and slow growth in manufacturing advances.

Traditionally the Scottish public have preferred savings accounts to current

*The authors are all participants in a project sponsored by the SDA examining the Scottish financial sector.

competition from other institutions for savings deposits combined with, until recently, their more favourable tax treatment, and the growth in the use of cheques in Scotland as a method of payment. In turn, this growth has been dwarfed in the UK as a whole by the growth in the use of credit cards. Further changes in the method of payment, with increased use of electronic fund transfers, are to be expected.

The last fifteen years have been noteworthy for the expansion of the banks into ancillary activities. The Bank of Scotland has used its subsidiary the British Linen Bank to offer a range of merchant bank facilities as well as instalment credit and leasing. The Royal more recently, has acquired Charterhouse Japhet to strengthen its merchant banking business and has devoted considerable resources to its insurance services and similar activities. It has divested itself of its 39% holding in Lloyds and Scottish Group finance house previously its main source of business in hire purchase and instalment credit, and this has led to a revamping of its remaining companies in this field. The divestment has been seen by many as a prelude to Lloyds Bank selling its remaining shareholding in the Royal Bank Group but Lloyds remain holders of 16.9% of the equity. The abortive takeover attempts for the Royal Bank has led to extensive reorganisation of the Royal Group and a long overdue integration of different segments of the business, most notably Williams & Glyns, into a more cohesive group.

The result has certainly strengthened its overall position and, investment funds permitting, will probably slowly shift the emphasis of the group from being a Scottish Clearer with English subsidiaries to a UK-wide clearing bank. It illustrates very clearly the dilemma faced by Scottish institutions. To remain committed almost solely to the Scottish market is to restrict growth and ignore profitable opportunities elsewhere. It is also to invite takeover attempts with no certainty, in the changed climate of competition, that such threats would be thwarted. To expand south of the border or internationally is to shift the focus of the firms' operations leading possibly, in time, to the bank moving its headquarters to London or further afield where the main financial markets are situated. The consequences for Scotland would be twofold: a change in the composition together with a possible fall, or at least reduced growth, of employment, and the possible impact on the Scottish financial sector as a whole.

The continued existence of the Scottish Life offices indicates that this process is not inevitable although their experience may not be typical since the life offices are essentially portfolio management organisations and are not substantially involved in the short-term money markets based in London. Their mutual basis also implies that they are protected against takeover threats. Greatly improved communication facilities should reduce the need to locate in London although it is too early as yet to assess whether the impact of the communications revolution is enough to prevent the tendency for financial agglomeration around London that has been so much a feature of the post-war period. The impact on the financial sector of a move out of Scotland of one of the banks would be dramatic. The banks and their clearing facilities provide a level of business for specialist services such as accounting, auditing, legal and printing to develop profitably. The existence of these services, together with a pool of trained employees attracts other firms and provides the basis for a financial sector. The concentration of financial services may in turn induce innovation in other sectors as a consequence of the presence of sophisticated information services and other facilities.

The acquisition by Standard Life Assurance of Barclay's 34% shareholding in the Bank of Scotland has guaranteed for the present, its future as a Scottish-based institution. However, the opening up of financial markets with the breaking down of barriers to competition between institutions suggests that the bank's future may lie as part of an integrated financial conglomerate, offering not only banking facilities but a wide range of insurance and other financial services.

Recently, the three Scottish clearing banks have been joined by the Scottish Trustee Savings Bank. Its 286 branches and assets of £1,200m make it smaller than the older established Clearers but still a substantial competitor for banking business. The TSB in Scotland has traditionally had a surplus of savings over the needs of its customers arising from its strength in the domestic retail market and its comparative weakness in the industrial and commercial markets. To absorb the surplus it has expanded its personal and business lending activities and competes vigorously with other intermediaries such as building societies for domestic mortgage lending business.

Competition in the corporate sector of the market is intense. In addition to the Scottish merchant banks such as Noble Grossart, who specialise in providing financial advice to companies which is independent of the major banks, there are a considerable number of foreign, particularly American, banks as well as English Clearers and merchant banks. Specialist banks serving primarily the Asian, Indian and Chinese communities in Scotland have also been established.

In the retail deposit market the major competition for funds has arisen from the Building Societies. Although only one Scottish society, the Dunfermline (assets £244m end 1984) is of any size, there has been a major expansion of building society activity in Scotland. In 1971 there were 119 building society branches representing 6.8% of the total clearing bank and building society branches in Scotland. By 1984 the number of branches had increased to 452 and represented 23.4% of the total. The growth in building society accounts has also been remarkable. In 1968 only some 8% of adults held accounts compared to 34% in 1984. But this is still well below the UK as a whole (57%).

In 1970 net funds of the building societies available in Scotland arising from that year's activities, were £101m. Lending was £83m and the difference provided a surplus of £18m. By 1974 the surplus had disappeared and this deficit pattern has been repeated in every year since. By 1984 lending was £1,686m resulting in a £272m flow of funds from the rest of the UK to Scotland. This flow reflects the rapid growth in the demand for owner-occupation in Scotland, growth that is emphasised by the increase in lending by other institutions for house purchase over the period.

One other major competitor for funds in the savings market deserves mention. The National Savings Bank is located in Glasgow having moved there in 1966. It handles deposit and withdrawal facilities throughout the Post Office system but its impact on the Scottish financial system is small since all the funds collected are channelled directly into Government securities.

Scotland is well represented in the insurance industry. In addition to General Accident, the fourth largest composite insurance company in the UK, there are nine Scottish life assurance offices representing in total a 15% share of UK long-term premium income and a slightly higher proportion of assets. Several of the offices undertake a substantial part of their business overseas, particularly Standard Life, whilst of their UK business, approximately a sixth emanates from Scotland. Over the period 1971 to 1981 they experienced a five-fold growth in premium income and a four-fold increase in assets.

The Scottish life offices are organised on a mutual basis so that increases in assets accrue entirely to the policyholders with no diversion to shareholders. The advantage of this arrangement is obvious although its opponents maintain that the system reduces managerial incentives since the management are not subject to external shareholder pressure and, hence, have no incentive to keep costs down, to innovate or to take risks. Such incentive and motivation (Agency) problems are not experienced by mutuals alone. Recent evidence would appear to favour the mutual form since the ratio of expenses of the mutal Scottish life offices (management expenses plus commission as a percentage of premium income) was around 15% in 1981 compared to 21% for UK insurance societies, mutual or otherwise as a whole.

The published annual comparisons of how policyholders have fared also indicates that some of the Scottish offices have done very well, although evidence on the efficiency of the stock market suggests caution in the interpretation of investment results. However, by restraining management expenses there may be a real benefit to policyholders so that the ivestment fund grows at a faster rate than is otherwise possible. Of course, low management expenses are not necessarily an unmitigated blessing since they may stem either from an efficient, cost conscious management or from a dormant management team that is failing to investigate new opportunities. Innovation in both products and technology may be expensive in the short-run but may lead to growth and economies of scale in the longer-term.

Unlike the Scottish life offices, General Accident is a publicly quoted company. Of its premium income (in excess of £1,650m in 1984) 40% arises in the UK and 10% of this from Scotland. General Accident dominates the UK private motor insurance market with one sixth of the total and is well represented in the fire and accident insurance market. Fierce competition in the insurance market has resulted in General Accident making an underwriting loss in many recent years (£268.3m in 1984) and poses interesting questions about the use of shareholders funds and the desirability of the company's continued existence in its present form.

Besides providing life assurance, the Scottish life offices also play an active part in the pension fund market. However, they are not alone in this market while a number of investment management companies also offer pension fund services.

The movement of investment management companies into the provision of pension schemes, highlights a major trend in financial markets in recent years. The demarcation lines between different activities have been progressively reduced as a result of regulatory, fiscal and innovatory changes so that intermediaries are often involved in a range of financial activities. This is particularly apparent in the field of investment management. Scotland has traditionally been strongly represented in the management of investment trusts and the experience gained has been employed in the management of other areas such as pension fund portfolios. Scottish-managed investment trusts represent 36% of the UK industry and exceeded £5,000m in 1984. Four groups each managed more than £600m of investment trust assets whilst the Scottish industry also included a number of very large independent investment trusts although the number of such trusts has been falling as predators, particularly pension funds, have attacked the sector. Joining a management group provides some means of defence against such predators, although it is not necessarily in the best interests of the shareholders.

In contrast to the strength of the investment trust industry, unit trust management is poorly developed. Out of UK total funds under management of £15,100m at the end of 1984 Scottish management groups managed around 3% although the figures ignore the management by Murray Johnstone of TSB International Unit Trust (£217m 1984). The largest Scottish unit trust is operated by Standard Life and ranked 25th largest in the UK in 1984. Particularly noticeable is the low representation in the insurance-linked business. There are serious grounds for concern that too much Scottish investment management is represented in the traditional, slower growing sector of the investment management industry, and too little in the area that registered rapid growth. It appears to be a serious indictment of the investment institutions management.

Innovation and entrepreneurship are significant forces in financial markets. They are also of importance in other areas of economic activity such as industry and commerce. For many years it has been a major concern to stimulate such activity and to make sure that new activities are not hindered by a shortage of funds. The provision of Venture capital has been identified by a number of institutions as a potentially profitable and useful activity and has led to a variety of institutions in addition to the merchant banks, the traditional suppliers of such funds, offering assistance to small ventures. The high risk and small size of many possible beneficiaries often limit the involvement that private institutions are prepared to make so that it is necessary for ventures to receive assistance from the public sector institutions such as the Scottish Development Agency which have been set up to fill gaps in the capital market.

A full assessment of the health and vitality of the Scottish financial sector is beyond the scope of this article. Two themes, innovation and regulation, have recurred, however, and it is useful to consider their implications for the future of the Scottish sector. The last decade has been noteworthy for the sheer scale of financial innovation with innovations in: new securities, particularly floating rate instruments, options and futures; institutional forms, notably the financial conglomerate and the boutique; and computer and communications technology with the advent of advanced information systems, automated tellers, electronic fund transfer, home banking and extensive computerisation of the clearing process in cheque transfer.

Scottish institutions have not been backward in their response to technological innovations. Indeed, several of them have been at the forefront of UK innovations. They have, however, been slow to move into new securities and have missed out on some fast growing sectors of the market. The starting-up of new institutions particularly in investment management and on the fringes of merchant banking represents one of the few bright spots indicating vitality and innovatory activity.

The Scottish institutions with the possible exception of the banks have made few obvious steps in the direction of the financial supermarket. Of the investment management firms, a few undoubtedly have a long-term future as financial boutiques offering specialised investment services but this is unlikely to be a viable alternative for all of the institutions. The removal of barriers to competition, whether regulatory or technical, must favour large institutions or those able to respond quickly and effectively to changing conditions. The past performance of some Scottish intermediaries casts doubt on their ability to respond and provides grounds for concern.

The scope of regulatory activity in the financial services industry is particularly broad. Regulation affects all aspects of financial markets but the prevailing concept in recent regulatory changes has been to introduce a measure of consistency in treatment together with a reduction in the severity of regulation. There is a continuing concern to prevent fraud allied to a desire to allow innovation and change. The result has been a general loosening of the regulatory bonds bringing pressures, fuelled by innovatory changes, towards integration of different sectors of the financial markets. Barriers to entry have been reduced and it has become more difficult for institutions to shelter from competition. Such changes are both a challenge and a threat to Scottish institutions. A challenge because they open up new opportunities. A threat because known and tested methods must sometimes be abandoned if enterprises are to continue. Takeovers have become easier and some institutions face a challenge to their continued existence. Scotland's financial sector can only prosper if it adapts to the new environment.

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