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The Scottish financial sector: performance and prospects

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Making a difference to policy outcomes locally, nationally and globally

OCCASIONAL PAPER

The Scottish Financial Sector; its performance and future prospects

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I Introduction

The purpose of this paper is to review the performance of Scotland's financial services (FS) sector and its three principal sub-sectors and to draw out strategic issues for the sector and policy makers in Scotland to consider. The paper draws on analysis of official economic statistics undertaken by economists at the Fraser of Allander Institute and work by HMT, as well as from conversations with senior members of Scotland's financial community.

Section II draws together a time series analysis of output, employment and value added (GVA) of the FS sector and its principal sub-sectors. This is particularly important given that the sector has experienced a very turbulent period over the past six or seven years. The analysis has been much aided by the data and analysis provided by economists at the Fraser of Allander Institute (FAI). However, it should be noted this assistance cannot fully compensate for the inconvenient truth that official data on the sector are not complete in their sub-sectoral breakdown and hence conclusions have to be cautious in places.

Having considered this analysis and its implications, Section III turns to the major influences which have impacted on the sector in recent years, those which are being felt now - and will be felt into the future. In this context the author has benefited from discussions with Scottish Financial Enterprise and senior contacts within the financial services sector in Scotland.

Section IV draws together some key conclusions as to the current and future focus of both key players in the FS sector and for policy makers in Scotland and proposes some possible early actions to help reduce perceived risks and signal that Scotland remains a competitive location for the financial services industry, as it has done for so many years.

There can be no doubt that a wide variety of major influences are at play at present and that the future, domestically and internationally, is rife with uncertainties. Again this implies that the conclusions drawn regarding the outlook of the sector have to be cautious, as do any recommendations regarding appropriate policies and interventions for the sector. It is hoped that this paper raises some key strategic issues for those involved with the sector –industry players, policy makers and politicians - and that further consideration of these issues and risks may lead to outcomes that are beneficial to the Scottish economy and the economic health of this key sector; or at least help to mitigate some downside risks.

Of course it should be stressed that the responsibility for the analysis, the views expressed and the conclusions drawn is entirely that of the author.

II The recent performance of the financial services sector in Scotland

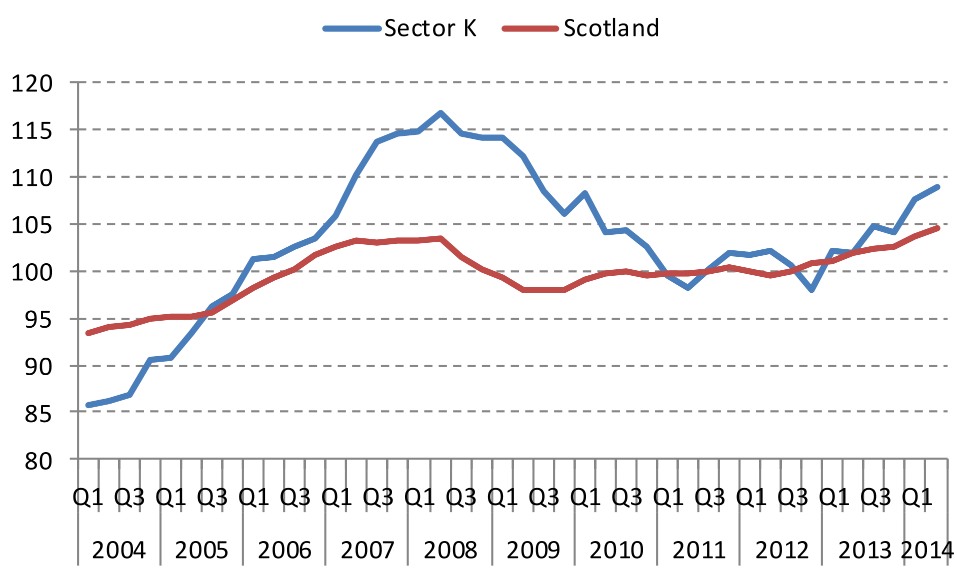
A statistical analysis of the sector has to be based on data covering 'Sector K' in the UK's 2007 Standard Industrial Classification (SIC2007). This is further broken down into three components, namely: -

67 - Financial services, except insurance and pension funding
68 - Insurance, re-insurance and pension funding services, except compulsory social security and pension funding
69 - Services auxiliary to financial services and insurance services.

Clearly this is neither as detailed nor as clear a breakdown as one would wish. In Scotland we tend to think of the three key components of the sector being banking, insurance and asset servicing. For the purposes of this analysis we take banking as sitting in (indeed dominating) 67 and insurance and asset servicing in 68 – with a potpourri of (much) smaller activities sitting in 69.

Data on trends in Gross Value Added in Scotland from 2004Q1 to 2014Q2 are set out in Figure 1, for the financial services (FS) sector as a whole and for Scotland, in index form, based upon 2011 = 100 in both instances.

Figure 1: GVA index for Sector K and Scottish economy, basic prices, Index: 2011 = 100



Source: Gross Domestic Product, 2nd Quarter 2014 (Scottish Government)

Figure 1 shows that the while financial services sector out-performed the Scottish economy as a whole over the ten year period from 2004 to 2014, FS growth was most marked from 2004 to 2008, with the index rising from c.85 to above 115 while the Scottish economy index rose only gently from 95 to below 105. Post 2008 Sector K fell back sharply as the financial sector-induced recession struck, declining to around 100 in 2010, 2011 and 2012, before edging up once more over the last two years towards 110. The Scottish economy index fell back far more gently and has risen more slowly to reach 105 in 2014Q2. The index rise over the whole period for the FS sector was c.25 index points, while for the Scottish economy as a whole it was only 10 index points.

In order to assess relative performance within the FS sector we set out in Tables 1,2 and 3 GVA compounded average growth by sub-sector and the equivalent for output growth and employment growth sector for the periods

1998-2011, 1998-2008 and 2008-2011. These figures are contrasted with the equivalent results for the FS sector as a whole and for Scotland. The data come from the Scottish-Government Input-Output tables, as re-calculated by the Fraser of Allander Institute.

Table 1: GVA growth by sector, compound average growth rates, years as noted, %

period	Banking	Insurance and pensions	Auxiliary financial services	FS Sector	Scotland
1998 to 2011	9.8	2.6	2.2	5.7	4.2
1998 to 2008	12.8	7.3	8.7	9.7	5.2
2008 to 2011	0.3	-11.8	-16.7	-6.5	1.1

Source: Scottish Government Input-Output tables and multipliers, July 2014 and FAI calculations.

Table 2: Output growth by sector, compound average growth rate, years as noted, %

period	Banking	Insurance and pensions	Auxiliary financial services	FS Sector	Scotland
1998 to 2011	8.1	5.7	0.7	6.0	3.9
1998 to 2008	10.2	11.7	6.6	10.5	4.9
2008 to 2011	1.3	-12.2	-16.8	-7.6	0.3

Source: Scottish Government Input-Output tables and multipliers, July 2014 and FAI calculations.

Table 3: Employment growth by sector, compound average growth rate, years as noted, %

period	Banking	Insurance and pensions	Auxiliary financial services	FS Sector	Scotland
1998 to 2011	0.0	-4.0	3.0	-0.1	1.0
1998 to 2008	2.7	-0.8	1.5	1.6	1.8
2008 to 2011	-8.6	-14.0	8.4	-5.5	-1.7

Source: Scottish Government Input-Output tables and multipliers, July 2014 and FAI calculations.

For banking GVA and output grew rapidly (average double digit rate per annum) up to 2008 and then slowed sharply. However, there was a modicum of growth in the period 2008-2011 for this sub-sector, which was emphatically not the case for insurance and pensions where GVA and output fell back by 11 or 12% per annum over the period 2008-2011. There was an even larger decline by both measures for auxiliary financial services, though it should be recalled that this sub-sector is much smaller than the other two. Clearly the knock-on effect of the banking crisis was felt strongly across the whole FS sector – with the most limited effect in the sub-sector containing banking! (It has to be noted that the suggestion in the data that banking output grew between 2008 and 2011 is counter-intuitive. With employment down sharply and profits from the major two banks generally negative the expectation has to be that output declined. As noted above the data are not perfect!)

Turning to employment, there was much less growth in the earlier years than in output or GVA, a sign of increasing productivity, and then a sharp fall for ‘financial services’ and insurance and pensions. Employment in auxiliary financial services rose by over 8% pa from 2008-2011. One explanation could be a shift to lower wage, lower value-added, activities as the crisis struck.

Turning to a comparison between the FS sector as a whole and Scotland, it is clear that the degree of volatility was much greater for FS – stronger growth of output and GVA up to 2008 and then decline while for Scotland very slow growth was maintained. Turning to employment, again the fall back was greater in the FS sector than it was for Scotland as a whole; for the period 1998-2011 as a whole FS employment fell marginally while Scottish employment grew by 1%.

As a result of these differing trends the financial sector as a share of Scotland's economy waxed and then waned over the period. The FS sector's share of Scottish GVA rose from 5.77% in 1998 to 7.11% in 2003 and 8.77% in 2008, before falling back to 6.94% in 2011. Banking more than doubled its share of Scotland's GVA in the decade from 1998 to 2008. (See Table 4.)

Table 4: GVA for sector, and Scottish economy, £million, cash values

	1998	2003	2008	2011
Banking	1,248	2,564	4,169	4,206
Insurance and pensions	1,864	2,540	3,785	2,595
Auxiliary financial services	559	626	1,287	743
Financial Services Sector K	3,671	5,730	9,241	7,544
Scottish economy	63,578	80,646	105,331	108,690

Table 5 shows similar figures but this time for wage income.

Table 5: Output for sector, and Scottish economy, £million, cash values

	1998	2003	2008	2011
Banking	682	1,361	1,682	2,247
Insurance and pensions	679	1,073	1,443	912
Auxiliary financial services	441	543	1,012	571
Financial Services Sector K	1802	2,977	4,137	3,730
Scottish economy	38,003	50,121	63,576	65,546

The share of wage income accounted for by Sector K varies less markedly than was the case with GVA. It rose steadily from 4.74% in 1998 to 6.51% a decade later, before falling to 5.69% in 2011. This decline was down to insurance and pensions + auxiliary financial services, not sub-sector 67 where wage income rose in absolute terms and as a share of the Scottish total. It will be of interest to see more recent data when available and attempt to identify possible causes of these trends.

It is also possible to examine the overall contribution to the Scottish economy of the sector and its components by means of considering the 'multipliers' derived from the Input-Output tables. Data by sub-sector for the output multipliers and employment effects are shown in Table 6.

Table 6: Output and Employment Multipliers (Type “) by FS sub-sectors, 1998 to 2011

	Banking (67)		Insurance and Pensions (68)		Auxiliary Financial Services (69)	
Sector	Output multiplier	Employment effect	Output multiplier	Employment effect	Output multiplier	Employment effect
1998	1.8	28.9	1.7	17.2	1.8	28.4
2003	1.7	22.9	2.0	14.2	1.8	21.5
2008	1.5	14.7	2.2	9.7	1.7	17.4
2011	1.6	13.0	1.9	9.6	1.6	27.2

Source: Scottish Government Input-Output tables and multipliers, July 2014.

This shows that for banking the output multiplier (showing indirect and induced effects) has declined only marginally through the 13 year period from 1998 to 2011, while the employment effect has more than halved. [The employment effect is defined as the impact on total employment (jobs) across the economy of £1 million additional demand for a sector’s output. It therefore captures not just employment in the sector itself but through the ‘supply chain’.] The output multiplier trends are similar for auxiliary financial services , however, while the employment effect falls sharply to 2007 it then climbs back sharply again. This is another anomaly to explain. For insurance and pensions the output multiplier remains relatively stable, while the employment effect – as with banking - falls steadily through the period. The decline in the employment effect looks to be due to a combination of rising productivity and the impact of inflation - £1 million of demand at the end of the period is less in real terms than at the beginning and would mean lower employment impact even with productivity held constant. Nevertheless the halving of the employment effect of banking again appears difficult to explain rationally.

It is interesting to note that the output multipliers for banking and auxiliary financial services are relatively low – ranking 83rd and 74th respectively out of the 98 Scottish sectors included in the overall analysis. However, insurance and pensions (sub-sector 68) has a multiplier ranked 14th in terms of output and is the top-ranked employment multiplier of all sectors. This suggests that insurance and pensions is significantly more important than the other two elements of the financial services sector in terms of the secondary impacts on output in Scotland, while the greatest (relative) employment impact comes from auxiliary financial services.

Table 7: Contribution of sector(s) to Scottish output, £million (various years)

£million	1998	2003	2008	2011
Financial Services Sector r(K)	9,834	16,889	24,126	19,654
Banking	3,554	6,027	8,472	8,763
Insurance and Pensions	5,044	9,619	13,352	9,582
Auxiliary Financial Services	1,479	1,670	2,615	1,472

Note: Figures are in cash (i.e. nominal) values for the respective years.

Source: Scottish Government Input-Output tables and multipliers, July 2014 and FAI calculations.

The total contribution of the sub-sectors and the sector as a whole to Scottish output is set out in Table 8. This shows the output that would be lost to the Scottish economy if production in each of these areas was lost to Scotland and replaced by imports.

A comparison with Table 5 shows how much of the output lost is due to direct production and how much to the indirect and induced effects of that production.

One further - and critical - point is that a high share of output from each sub sector is exported out of Scotland. This amounts to 86.9% for auxiliary financial services, 79% for banking and only 36.9% for insurance and pensions. This reinforces the fact that Scotland is a significant UK financial services centre that sells - “exports” – financial products to the rest of the UK - and beyond. (At the same time the export figure for insurance and pensions looks low, given anecdotal evidence of the destination of most products from at least the largest companies.)

The Forecast

Finally it is necessary to note the latest FAI forecasts for the sector, in the context of forecasts for the Scottish economy as a whole.

The FAI is now forecasting, in its central forecast, GVA growth per annum of 2.7% in 2014, 2.2% in 2015 and 2.1% in 2016. For Sector K (Financial and Insurance Activities) the equivalent forecasts are 2.2%, 1.9% and 1.9%. In other words, as with the economy as a whole, the growth rate is forecast to decelerate through the period; and also growth in each year for this sector is expected to be lower than for the overall economy.

So far as employment is concerned, FAI expects an increase in full time equivalent employee jobs each year, by 2,500, 1,400 and 1,800 respectively in the three years, taking total FTE jobs to 96,650 by the end of 2016.

III Major Influences

The constitutional uncertainties

During the run up to the September 2014 referendum most financial services companies will have considered very carefully their options in the event of a ‘yes’ vote. In the course of producing a paper for the David Hume institute and Scottish Financial Enterprise regarding currency options for an independent Scotland, the author spoke with a number of senior representatives of companies across a range of financial service sub-sectors.

From these discussions, and consideration of the impact that independence could have had, it is clear that no bank or financial institution of any scale operating across the UK and elsewhere would have continued to operate from a legal (i.e. *de jure*) HQ in Scotland. In addition to the currency risk that independence would bring to companies with a *de jure* Scottish HQ, there were also significant regulatory and legal risks to consider. A prime example was the question of who would operate as lender of last resort. Bank customers were also questioning whether they would wish to retain assets in a bank based in Scotland, with the associated potential risks. These problems would have been resolved by the movement of *de jure* – but not necessarily *de facto* - HQs from Scotland, and hence location for regulation, etc., to somewhere in the rest of the UK.

There would also have been issues for those companies selling financial service products from a Scottish base across the whole of the UK. Maintaining their Scottish base would again have exposed these companies to currency, regulatory and legal risks; and further their customers’ outwith Scotland would have perceived risks associated with products – and usually long-term products – purchased from a company based in Scotland. Again the likely 'solution' would have been to move their *de jure* HQs, leaving in Scotland a range of activities, perhaps including a smaller (*de jure)* Scotland-based company to deal with sales of products to Scottish customers.

The movement of HQs would not have meant the end of the Scottish financial services sector, or indeed the end of the sub-sectors referred to above. As discussed below the impact would have been varied and uncertain.

Following the 'no' vote in September there has been no end to the constitutional uncertainties. Formally we have had the Smith Commission examining options for further devolution of powers to Scotland, including tax powers and potentially other powers of relevance to the financial sector. There is also the work of the Hague Commission to follow, looking more broadly at constitutional issues and options across the UK. Then of course there is the increasing possibility of a referendum on UK membership of the European Union in 2016, with uncertain results.

The UK general election will take place in May 2015, and the position on further devolution in Scotland should become clearer in the run up to and subsequent to that election. However, clarity on all issues will not be available at that time. The election for the Holyrood Parliament follows in 2016. While there are a variety of plausible scenarios for Scotland and the UK as a whole over the coming years, it is sufficient at this stage to note that the future constitutional position of Scotland, and indeed and perhaps more critically, of the UK within the EU, continues to suffer from risks and uncertainties, even after the result of the Scottish independence referendum. And the uncertainties will not wholly dissipate with the results of the 2015 UK general election.

Scottish-based financial service sector companies must be increasingly aware of these uncertainties, and also see that no early end to uncertainty is to be expected. Those companies which decided that leaving Scotland (in terms of *de jure* HQs) was the best option in the event of a 'yes' vote may decide that the state of uncertainties is such that it still makes business sense to consider moving HQs even after a 'no' vote. It is worth remembering the 'Montreal effect'. After the referendum on independence for Quebec in 1995 which also yielded a no vote (albeit by a very narrow margin) the Bank of Montreal moved its HQ to Toronto. However, there were key differences in language and culture in the case of Montreal which mean that one cannot necessarily read direct lessons from the Montreal experience for Scotland.

The potential EU referendum must be a significant and additional complicating factor for many. Those companies for which the UK market is paramount can decide upon HQ and operational bases without too much concern about any EU exit. However, those companies selling products across the EU must already be considering how they would best manage their affairs if the UK were to seek the exit door. Moving their formal (*de jure*) HQ from Scotland – or indeed London - to (say) Dublin might become a possibility for debate.

The Impact of these Uncertainties

It is very important to consider the potential impact of changes in location, etc. on the scale and significance of the FS sector in Scotland and indeed the sector's impact upon the Scottish economy.

The HQs of RBS and HBOS may *de jure* remain in Scotland, but in practice many (most?) of the most senior positions are now based south of the border. The 'centre of gravity' of these banks moved south some time back. If they were to move their formal *de jure* HQs to England, then it is not clear that there would be further major losses of top jobs in Scotland or indeed of business in Scotland related to decisions taken by top management.

We do have in Scotland a wide range and significant number of important, well paid and high value-added jobs in these two banks. Of course there is a spectrum of jobs in banking, as in the rest of the FS sector, ranging from the most senior and (very) well paid, through a range of high skill and high value-added activities, many back office in nature, to customer contact and call centre and other relatively low skill/low wage jobs. But the jobs towards the top end of the skill and wage spectrum are of greater importance in terms of the impact on the Scottish economy as a whole. Movement of the *de jure* HQs would not necessarily mean that those jobs still remaining in Scotland would be lost. Many of these jobs can be undertaken in a number of different locations. Choices have already been made between locations across the globe, and the jobs are here because a Scottish location provides a cost-effective means of delivering the services undertaken by the job holders. That should continue to be the case unless policy changes, perhaps as a result of further fiscal devolution, change the comparative cost-benefit of a Scottish base as compared to a base in the rest of the UK or further afield.

The importance of these jobs to Scotland should not be under-estimated. They add substantially to GDP and provide a career structure, making progress through a stimulating and productive financial sector career in Scotland feasible and attractive for many. These jobs will also have significant external effects – associated high level and high value services purchased from (inter alia) the business and financial service sector across Scotland and significant expenditures on housing and other goods and services by the job-holders. The purchases from other service sector companies are important to new and growing companies across the economy, including inward investors. Note that I am hypothesising high multiplier effects from such jobs.

In sum the key risk associated with any decision to move the *de jure* HQs of the two major Scottish banks out of Scotland is not the loss of HQ functions, as these have gone already, but the loss of the large number of jobs in the next tier which bring substantial direct and indirect benefits to our economy and are crucial to sustaining a high-skilled labour force. The consequent policy imperative is to focus on policies which tend to support the retention of these jobs in Scotland; and to avoid taking any steps which might threaten their continued location in Scotland. On this basis it would be inappropriate, for example, to introduce tax or other policies which could change the cost/benefit equation and lead to the departure to pastures new of skilled financial service sector jobs which add significant value to the Scottish economy. The focus must be on maintaining these medium/higher level jobs in Scotland. Indeed one could argue that it is better to let the *de jure* HQs go, and focus on retaining these jobs and aiming to attract many more. Scotland can continue to be a very attractive location for such jobs, across the financial sector.

The HQs of the smaller banks now emerging in the UK including Scotland are located in a variety of places. The same logic applies to them as is the case for RBS and HBOS. *De jure* HQ location is of low relevance. From an economic and strategic perspective Scotland wants more than just operational jobs which deliver products in Scotland or low skill/low pay back office jobs associated with delivering products globally. Scotland needs to focus on attracting and maintaining medium/higher level jobs in these new banks. We need to show that it makes sense to base these relatively high skill activities here, because Scotland provides a cost-effective location. If the location works for such parts of the operations of RBS and HBOS it should also work well for the banking operations of Virgin or Tesco or Sainsbury's.

A number of other international operators across the banking sector have located quite high level operations here. There may have been a hiccup while the referendum campaign caused uncertainties. There may be a risk that this hiccup could continue as the uncertainties continue. This risk must be addressed as soon as feasible. The Scottish

Government, along with SFE, SDI and SE, needs to be able to say that these companies will be welcomed here as before and that nothing will be done to diminish the attractiveness of Scotland as a base for such skilled activities.

One concern may be on the fiscal front. This needs to be addressed. Another may be regulatory. There seems to be no reason for not stating *now* that there will be no change, as the devolution process continues, in the regulatory structure. Regulation of financial services should remain a UK function, a reserved function, and the Scottish Government could state now that this is their firm intention. It is in all interests that this uncertainty be removed at once and a statement to this effect would be wholly consistent with the Smith Commission report.

Another key element of the attractiveness of Scotland for these operations is our skilled pool of labour, based upon our high quality Higher Education (HE) institutions. Generally there do not appear to have been skill shortages of any significance for the financial sector related to the output of the Scottish HE sector. Nevertheless it could assist for statements to continue to be made by all concerned parties that this is fully appreciated and that the Government and the Scottish Funding Council are prepared to work ever more closely with the financial sector, including potential new entrants to Scotland, to ensure that their needs are appreciated and catered for. There should be scope for ever closer links between Scottish HE and College providers of these key skills and the companies making use of the skills to understand better how one can serve the other. Similarly HE institutions may wish to attempt to foster research links with financial service companies – demonstrating that they have both the skills and the interest to support these companies at the highest levels, globally.

Of course the financial services sector in Scotland recruits from elsewhere than the Scottish Universities, and would also benefit from being able to recruit some of the most able foreign students undertaking graduate and postgraduate studies at Scottish Universities. In this context the recommendation from Lord Smith that the UK and Scottish Governments should ‘explore the possibility of introducing formal schemes to allow international higher education students graduating from Scottish further and higher education institutions to remain in Scotland and contribute to economic activity for a defined period of time’ provides an opportunity for a quick win to the benefit of financial services and other key Scottish sectors.

Similar issues arise when considering the potential impact of changes in the *de jure* HQ of financial service companies in other sub-sectors which provide products for sale across the UK and further afield. In some instances there would be a detrimental effect of significance from a change in HQ if both *de jure* and *de facto*. However, the *de jure* shift may be very difficult to prevent. But even if the *de jure* HQ moves there is no reason why most highly skilled, highly paid and high value-added jobs (with substantial multiplier impacts) should not be retained in Scotland. This is what we should seek. Such jobs would add far more to the Scottish economy than some lower level jobs retained to service the sale of products within Scotland and looking after the interests of existing customers based here.

Demographics and internationalisation

Of course there are also broader, global, trends which will impact upon the environment within which players in the Scottish financial services sector operate. Within the more developed economies demographic shifts are leading to an ageing population. This will also be the case in China. Dealing with retirement savings will be big and complex business, especially as defined benefit schemes disappear and the focus shifts to maximising value of defined contribution schemes and other forms of savings in an increasingly complex, global and transparent world of financial assets. Thanks to technological change, all interested parties will have access to all relevant financial data at any time they choose; and they will also receive an increasing flow of analysis and 'offers' from those wishing to aid them with their asset management decisions. Customers will be increasingly 'empowered' but may run the risk of also being increasingly confused!

Meantime the shift in economic power is continuing and accelerating. Brazil, Russia, India and China were the original BRIC economies, but now many others have joined them in the race to enhance economic growth, with accompanying urbanisation. These trends in the emerging economies are resulting in a very rapid growth in the relatively affluent – large numbers of consumers and large numbers of folk with funds to invest for their future prosperity. The extent of wealth to be managed in the Middle East should also never be under-estimated.

These diverse trends should all result in ever-increasing business for asset managers. Some analysts suggest that asset management will move centre stage and out of the shadows cast by the banking and insurance sectors. Scotland's asset management sector has performed extremely well throughout the past two decades. Informed parties within the sector consider that this success has helped to offset, at least partially, the decline since 2008 in output, value-added and employment in banking.

Retail and commercial/corporate banks may focus increasingly on national and sub-national markets, while effectively distinct investment banks operate regionally and internationally. [Discussion of investment banking has been avoided as this seems unlikely to be a major source of activity in Scotland or the type of activity which Scotland should work hard to attract.] Asset managers are likely to have to work on an international basis. Assets will become increasingly international. Different national markets may exhibit differing demand factors, but fully understanding the international supply side will be essential if asset managers are going to build their business.

Thus far the continuing consolidation in the fund management business has not led to major departures from Scotland. Companies and key jobs have stayed in Scotland when (for example) BNY Mellon bought Walter Scott and Aberdeen Asset Management bought Scottish Widows Investment Partners. It may be that Standard Life Investments and Baillie Gifford are the only two 'home grown' fund managers of significance, but what matters is retaining in Scotland the key jobs whoever owns the company and the key relationships, purchases, etc. which go along with these jobs.

The evolution of regulation will matter, as will the UK – and Scotland's – position within the EU. Based in Scotland, regulated at EU level but selling their services across at least Europe, the USA and the Middle East may increasingly be the model for Scottish-based asset managers in the future.

Competition will be intense and Scottish companies will need to demonstrate:

- access to all the required skills
- a close understanding of diverse international markets
- key technological capabilities
- a global telecommunications capability (and global fluency)
- all other abilities required to match competitors across the globe.

Given the deep business, skills and technological foundations / assets upon which the sector in Scotland is based, none of the above challenges seem insurmountable barriers to establishing global players of substance based in Scotland. Devolution of Air Passenger Duty to Scotland, as recommended by Lord Smith, should permit considerations of means by which the opening up and/or extension of routes to key destinations from Scottish airports can be encouraged, to the benefit of this key sector and others.

Competition in the Banking sector

A long standing question regarding financial services in Scotland has been whether the banking sector is sufficiently competitive to provide the required level of services to consumers of its products. It is therefore significant that the UK Competition and Markets Authority (CMA) has just launched a market investigation into components of the banking sector across the UK. (Its planned coverage is 'small and medium-sized enterprise (SME) banking and personal current accounts (PCAs)'.

There is more than one market for banking in Scotland. For the purpose of this discussion let us assume that there are four – retail banking to households; services to small and medium-sized enterprises (SMEs); lending and other basic services to large corporates; and investment banking.

It would be difficult to argue for large corporates and investment banking that there are distinct Scottish markets. The markets for these services are at least UK-wide. For lending to large corporates RBS and HBOS are the long-term incumbents, but they face mounting competition within Scotland from the likes of HSBC, Santander and Barclays. There do not appear, at first blush, to be barriers to entry of substance to prevent these banks and others entering this market in Scotland and competing with the incumbents.

The situation is similar with investment banking. It is worth noting that the trend may be for those providing investment banking services to separate from those providing other banking services, but companies in Scotland will face a range of options (including banks based across the UK and indeed globally) if they wish to hedge currencies or enter into other investment banking activities.

The structure of the retail banking sector in Scotland has changed in recent years, but the degree of competition appears to have been broadly sustained. There may be fewer building societies offering services to households but we have seen the entry of a number of 'challenger' banks – Virgin, Sainsbury's and Tesco to name three. These are now actively competing with RBS, HBOS and Clydesdale. These incumbents may have the benefit of a wider-ranging network of branches but (a) the rise and rise of on-line banking has somewhat reduced the relevance of the branch; and (b) we have seen all banks going through a process of branch closure reflecting this fact. The barriers to entry into the retail banking market may thus have been reduced to a limited extent.

The CMA has concluded thus far that 'essential parts of the UK retail banking market lack effective competition and do not meet the needs of personal consumers or small and medium sized enterprises (SMEs).' Their provisional conclusion that 'barriers to entry and expansion for newer and smaller banks remain significant and the markets remain concentrated, ***particularly in Scotland*** and Northern Ireland' (emphasis added) applies to both personal current accounts (PCAs) and SME banking. It will be interesting to see whether the CMA decides that there is a separate Scottish retail banking market and if so what views it forms in the more detailed phase of its work on the competitive state of that market.

In the author's view the SME banking sector in Scotland should be seen as the prime cause for concern. Again RBS and HBOS are the main participants, with a relatively small (and declining) involvement of Clydesdale. Data on shares of lending to SMEs in Scotland are not the easiest to acquire. An HM Treasury paper in May 2013 noted that in 2011 Lloyds/HBOS accounted for 36% of finance to Scottish SMEs and RBS 34%.

The market study recently undertaken jointly by the CMA and the Financial Conduct Authority (FCA) provides more data. In 1999 RBSG (33%), Clydesdale (31%) and BoS (25%) accounted for around 90% of business loans in Scotland, with Lloyds (4%) the only other provider of significance. In 2013 the picture had changed marginally – RBS (48%), Lloyds (26% -including HBOS), Clydesdale (14%) making 88% in total. Santander, the Co-op and HSBC all had shares of below 5%.Not the most encouraging sign of a healthy competitive banking market for SMEs in Scotland!

The CMA generally calculates the' HHI' index in studies of this type – a measure of market concentration. They have done so for SME banking in Scotland and determined that there continues to be 'a highly concentrated market even after the divestment from Lloyds'.

The CMA and FCA also concluded that 'significant barriers to entry and expansion remain' – noting in particular the continuing importance of a branch network and concerns expressed about the 'cost and difficulty for smaller and newer banks to gain access to payment systems which are key to offering Business Current Accounts.' The only new entrant noted was the Metro Bank. The 'challenger' banks will take some time to develop products for this market, with their clear initial emphasis being on households. The banks that are competing in the large corporate market are unlikely to work far down the company scale in the near future, given that for the smallest companies, especially but not only retailers, a branch presence will be critical for cash deposits, etc.

It is very clear that banks are not positively viewed by SMEs. The CMA/FCA study referred to above finds that only 13% of SMEs 'trust their bank to act in their best interests' and only 25% consider that 'their bank supports their business'. Overall the CMA concludes that the SME banking sector is one in which 'a believed lack of choice of providers combines with, and reinforces, SME inertia, apparently resulting in suboptimal outcomes for SMEs.' This suggests that the current market participants may well not be providing the range, quality, price, etc. of products for its customers that would be expected in a perfectly functioning market.

There are (at least) two strong reasons why the SME banking market specifically in Scotland should be a key element of the CMA study. First there is the concentration of SMEs in Scotland, a higher concentration of SMEs here than in the UK as a whole, and consequently this sector is of critical importance to the Scottish economy. Second, the SME banking market is significantly more concentrated here than elsewhere in the UK's nations and regions with only two participants of substance and no signs of significant early changes to be anticipated. The study of personal current accounts will be of interest but the examination of the SME banking market even more important – certainly a topic worthy of the CMAs careful, informed and objective analysis. We will learn more over the coming months and learn their conclusions at the end of their study period. One further point to note is that, if the Smith Commission recommendations are adopted then Scottish Ministers will in future have the ability to require the CMA to undertake a full second phase investigation 'in relation to particular competition issues arising in Scotland.' This may open up opportunities for further helpful examinations of aspects of this and other sectors.

IV Some conclusions and recommendations

The impact of the financial sector –induced recession starting in 2008 was felt across the globe. Given that the two major players in the Scottish financial sector – RBS and HBOS – were major casualties of the banking sector collapse, both ending up largely (UK) state-owned, it is remarkable that the sector here has not suffered more than has been the case. This is demonstrative of the robustness of the sector and its diversity. The Scottish financial sector amounts to much more than just two major banks. Clearly asset management and insurance are key elements, as are a range of ancillary activities and other banks – large and small, UK and overseas. This robustness and diversity provides a powerful base for future success, to the benefit of our economy as a whole.

Another point stressed throughout is that Scotland benefits most from relatively high wage, high value-added and high skill jobs within the sector. These have the greatest direct impact on the economy, but also yield larger multiplier effects on GVA and employment. By no means all of these jobs are tied in locational terms to the HQs of companies. Scotland has attracted many such high level jobs for companies based in the rest of the UK and further afield, and has also retained many for RBS and HBOS/Lloyds as their *de facto* HQs have moved elsewhere. There is a risk that more companies may formally relocate south of the border as risks and uncertainties on the constitutional front continue (and outwith the UK in some instances if risks grow regarding a possible UK exit from the EU). However, such moves should not be seen as necessarily implying the loss to Scotland of high level jobs.

It will be critical that the Scottish Government confirms its commitment to providing the environment within which it makes sound business sense to locate a wide variety of high level financial sector jobs in Scotland. Professor Nick Crafts has made a distinction between horizontal and vertical interventions to support business. The latter – vertical – interventions include the age-old policy of 'picking winners', and other specific interventions in support of specific businesses or so-called 'key' sectors. Crafts suggests a preference for horizontal interventions, a focus on providing the supportive environment for flourishing business. This can include an emphasis on skill development (general and specific), provision of key physical and digital infrastructure, internal and external communications, a positive and clear legal and regulatory environment and encouragement of external links in a variety of ways. Emphasis on the horizontal is strongly commended for the financial sector in Scotland.

Skills

Scottish Higher Education and Further Education institutions already have close links with businesses in the financial sector; and there are doubtless equally close links involving the Scottish Funding Council, Universities Scotland, Scottish Financial Enterprise, Scottish Enterprise, CBI, IoD, SCDI, etc. Indeed there is a skills/labour supply sub=group of FISAB that brings together most of these bodies. However, the availability of key skills on a continuing basis from these institutions, along with their interest in continuing skill development ('lifelong learning') and research of relevance will all be critical in attracting and retaining high level jobs. The sector and its component parts will continue to change at pace in the years ahead. Our institutions must ensure that they match, and preferably anticipate, such change; and demonstrate their overwhelming commitment to meeting the requirements of the sector.

An early follow up to the Smith proposal regarding allowing foreign students to stay on to work in Scotland for a specified period would also work to the advantage of financial services and the proposed emphasis on high skilled and high value added jobs.

Regulation

Following the outcome of the referendum, key elements of regulation and supervision of the financial sector remain as functions reserved to the UK rather than devolved to Scotland. One straightforward means of reducing uncertainties facing the financial sector would be for the Scottish Government to indicate immediately that, irrespective of the findings of the Smith or Hague Commissions, it is their firm intention that financial sector regulation and supervision should remain a UK function for the foreseeable future.

Life assurance and pensions

Providers in these sectors face a UK-wide threat from deregulation of the pensions' market – e.g. ending the restriction on the timing of being able to withdraw funds from pension pots. Companies based in Scotland also face the threat of a differing pensions' regime here. It that was to materialise then Scotland-based companies selling across the UK would find the regime in Scotland of real difference from the rest of the UK, where some 90% of their market is likely to lie. An obvious response would be to re-locate their core business outwith Scotland and keep a business in Scotland to service Scottish customers. Thereby they would avoid the risks of selling across a border to a different regime. It is possible that even with a *de jure* move of HQ Scotland could retain key high value-added jobs, but the risk is clear.

The financial and fiscal environment

The outlook for the public finances in Scotland and the rest of the UK remains difficult and uncertain. The situation will be made more complex in Scotland as we await the follow up to the Smith Commission and subsequent decisions at Westminster and Holyrood as to further devolution of fiscal and other matters to Scotland. It looks inevitable that Scotland will gain a substantially larger share of tax-raising powers than at present; although the specifics as to what may change are by no means clear. The Scottish Government cannot be expected to enter into any firm and early commitments on this front. However, it would be helpful to those in the financial sector who are planning location decisions on a variety of fronts for Government to stress that it values the sector and will strive to retain a competitive environment for high skilled, high wage and high value-added jobs to be located within Scotland. This would be beneficial for both Scottish and UK companies and actual and potential inward investors.

Infrastructure

Perhaps the most important aspect of communications for the financial sector in the future will be digital. Across all key sub-sectors access to the latest and best will be critical in order to compete. For banking this will largely be a matter of within the UK, with some stretch to Europe, but for asset management the requirement will be global. Both Governments must continue to stress their commitment to high speed and broad digital communications across Scotland – in line with the 'best of class globally.

Communications/air services

The emphasis here has to be on international as well as domestic communications. For asset management, in an increasingly globalised market, good communications by air with all major centres of demand and supply will be essential. One critical issue is likely to be air services, access by direct and/or highly convenient flights from Scotland's airports to a variety of destinations. Related to this will be the cost of travel. The Holyrood Government will wish to be strongly supportive of increasing the number and range of direct flights from Scotland's airports and doing what it can, directly and indirectly, to constrain costs. Devolution of APD should be a significant benefit to this process.

SME Banking

Reference has been made above to the Competition and Markets Authority study of banking which has recently been launched. This will cover retail current accounts and banking for small and medium scale businesses. The latter is of great importance to the Scottish economy. The CMA has determined that there is a distinct Scottish market for SME banking. All interested parties in Scotland should endeavour to follow this CMA work closely and provide the CMA with a range of evidence on the importance of the sector in Scotland, the problems caused for SMEs by the limited number of providers at present and how the service might be improved to the benefit of the Scottish economy. The Scottish banks, principally RBS and HBOS, will be providing major inputs. Other key players should aim to match that from a very different and perhaps more objective perspective.

In sum, the financial services sector in Scotland has been an important and high performing component of the Scottish economy, albeit one hit by the financially-induced global recession from 2008. The FS sector as a whole has, somewhat surprisingly, faced up successfully to the consequent pressures, which hit the banking sector in particular. Indeed, the negative impact of these changes on output and employment has been much less than anticipated, reflecting the diversity, resilience and competitiveness of the FS sector in Scotland.

Certainly the future for Scotland's financial service sector could be bright, despite the uncertainties which continue to loom and the risk of further moves of *de jure* HQs to other parts of the UK or even the EU. Components of the sector have performed remarkably well in recent years, despite recession and banking sector turmoil. Scotland is a favoured location for footloose financial sector activities, including a variety of activities employing relatively high skilled, high value-added and high wage personnel. These activities and jobs are not inextricably linked to HQs. Given skill availability and a variety of other factors Scotland can be a competitive location for such activities.

The emphasis of all engaged in and with the FS sector should be on creating the environment in which Scotland continues to be an attractive environment, with government and all key parties showing, by words and deeds, that attracting and retaining such important jobs and activities is seen to be very clearly in the interests of Scotland as a whole. Asset management in particular looks to be a relatively unsung Scottish success story, facing a very exciting global future, and one in which Scottish-based activities should be well placed to thrive. The future for the Scottish sector as a whole is much more than being a safe haven for call centres and low value-added back office jobs. Scotland has the skills and experience to be much more than that, and to achieve its potential as a major European FS location. Making the most of this sector should continue to be a key priority for the years ahead.

About the author:

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He has a distinguished career as an economist and economic commentator and was Group Chief Economist at the Royal Bank of Scotland (1993-2005). He is currently is a member of the Board of Scottish Enterprise and Chair of the Royal Zoological Society of Scotland and was a long-standing Director of the David Hume Institute (2004-14). He is a fellow of the Royal Society of Edinburgh, of the Chartered Institute of Bankers and the Royal Society of Arts.

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