



Scottish Council for
Development and Industry

POLICY SUBMISSION

The way forward for Scotland's banking, building society and financial services sector

Submission from the Scottish Council for Development and Industry

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SCDI is an independent and inclusive economic development network which seeks to influence and inspire government and key stakeholders with our ambitious vision to create shared sustainable economic prosperity for Scotland.

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1. What is your view on the cause, nature and impact of the recent difficulties in the financial sector in Scotland?

The causes of the worldwide banking crisis have been well documented: global imbalances in trade especially between China and the US leading to the availability of very cheap credit and increasing consumer debt in the West, the under pricing of risk and the collapse in financial markets that followed, leading in turn to a seizing up of capital markets and a huge loss of liquidity. The cause and nature of the recent financial crisis has been much the same in Scotland as in other parts of the UK

Given the comparatively small size of their home market, in order to grow and retain their independence the Scottish banks sought to take advantage of the opportunities created by the rapid globalisation of the world's financial system. They did so successfully and the Scottish economy has benefited, but this also left them more exposed to a credit crunch.

None of the Scottish banks were involved in selling sub-prime loans, although they were exposed to the sub-prime market through the purchasing of derivative products. The impact has perhaps appeared to be more pronounced in the financial sector in Scotland than in other regions of the UK, with both of the largest Scottish banks having suffered major difficulties and been required to accept state intervention/funding.

But we must remember that the asset management industry has fared relatively well compared with other parts of the UK and world markets. Depending on the methodology used, Edinburgh remains the city in the UK with the second largest number of funds under management.

2. What evidence do you have on the issue of the availability and the cost of credit and what effect have the initiatives undertaken by the banks, government bodies, regulators and others had?

The UK banks have all expanded lending in recent months, but there is no doubt that credit has become more expensive and less readily available, as evidenced in the Scottish Government report SME Access to Finance¹

Some businesses have seen their credit lines withdrawn or substantially reduced leaving those businesses considerably exposed. Others have seen their existing facilities renegotiated, although this has been mitigated to an extent by linking rates to BoE base rate or LIBOR. A third symptom has been higher fees and costs for overdrafts or loan arrangements.

This has had an impact on every sector of the economy from construction and real estate, to oil and gas.

It is impossible to quantify the impact of the actions of various government bodies, but it is clear that the following actions have all delivered greater liquidity in the markets than would otherwise have been the case:

- HM Government's intervention to buy a stake in some of the banks
- HM Treasury's Asset Protection Scheme
- Aggressive cuts in interest rates by Bank of England
- Quantitative Easing

¹ <http://www.scotland.gov.uk/Topics/Economy/access-finance/report>

In terms of initiatives by the Treasury and the regulators, the increased capital requirements demanded of the banks initially meant that there was less funding available for lending, although this may now be balancing out. The huge focus (rightly) on risk management by the regulators will impact the banks and make it likely that they will act more cautiously, at least in the short term, in terms of further expansion and in terms of lending.

It was also inevitable that Quantitative Easing would initially contribute to efforts to restore balance sheets before releasing capital reserves for lending. Now that this repair has been substantially completed then lenders will be inclined/expected to lend out capital rather than sitting on large reserves attracting BoE interest rates at such a low level it offers them a very poor rate of return.

The growth in credit was partly fuelled by the entry of international banks into the Scottish market offering very competitive terms. However, many of these banks have retreated to their home markets. Their withdrawal from the Scottish market has compounded the lack of credit availability, and they show no sign of returning any time soon. This means we are expecting those remaining indigenous lenders to return to the lending levels they themselves previously maintained and to also somehow fill the credit gap left by those banks who have withdrawn. But it must be questioned whether this is either practical or desirable, given the demands to return to a more 'balanced' banking system.

There is evidence from SCDI members that debt finance is becoming more freely available, but it remains difficult to borrow for property and leverage-financed transaction due to banks' existing exposure to these sectors and their existing bad debts significantly reduce appetite for further lending.

3. What changes can be expected as part of the ongoing and future restructuring plans in the financial services sector within Scotland?

It seems that further rationalisation is inevitable at many of the major employers in financial services.

However, there is also the very real possibility of new jobs coming to Scotland, with for example Lloyds Banking Group's Insurance Division anchored in Edinburgh. We have to maximise the potential for Edinburgh to host not just group headquarters functions, but also to be the site for business divisions and units, as well as maximising the business opportunities that this brings for professional and associated services. Glasgow's International Financial Services District has attracted 15,000 new jobs since it was created in 2001, with a further 1300 announced in this year alone.

Combined with Royal Bank of Scotland's anticipated strong recovery over the next 3-5 years and the arrival of Tesco Personal Finance and Virgin Money in Scotland, and potentially other newcomers, it seems likely that overall there may be relatively more jobs retained and created in Scotland than in other parts of the UK.

It is clear that Scotland has many advantages as a place to be based, including the significant inward investment incentives which are currently available from Scottish Government agencies and the business and property markets.

4. How might these changes affect the business and retail banking market in Scotland, access to project finance, a reduction in competition on the 'high street' for lending, the plans for the retention of functions and 'headquartering' etc and what can the public sector in Scotland do to ensure the best possible result for Scotland?

There is no evidence that any of the issues highlighted are attributable in any way to a lack of competition.

All countries with any significant financial services industry have been adversely affected by the recent banking crisis. Whilst a relatively large percentage of the overall Scottish headquartered banking industry was very seriously adversely impacted by the crisis, the indications are that on a European and international basis the Scottish "brand" has not been affected any more than the brands of other parts of the UK and other countries around the world with material banking industries. As stated above, the crisis did not originate in Scotland and the Scottish banking industry is already showing signs of robust recovery.

Government at all levels must ensure that Scotland has world class infrastructure links such as international flights, access to Heathrow, better and faster rail services between Glasgow and Edinburgh, high speed trains to and from London and that incentives and skills training is encouraged to ensure continuing high skills levels across all areas of financial services, including independent legal, accountancy and other professional support functions, in the financial centres in Scotland.

The roll-out of wi-fi on key public transport routes would make Scotland more attractive. SPT now provides a cellular network across the 15 Glasgow subway stations covering all users on the O₂ network.

5. What are the current employment levels and skills base in the financial sector in Scotland and how may these change? Additionally, what are the types of jobs that might be expected to be lost as part of any restructuring plans?

Whilst a number of senior jobs will be lost in Scotland and recreated in London, there seem to be reasonable prospects that for senior banking positions north of the border in the medium to long term. There are already signs on a UK wide basis that banks and insurers are starting to recruit for the first time since the Lehman Brothers crash.

Stephen Hester of RBS is on public record as saying that he anticipates a slightly larger percentage of cuts in England and Wales than in the RBS Scottish based workforce, due to the lower costs of retaining staff in Scotland and the very high calibre of staff.

The merger between Lloyds TSB and HBOS will lead to job losses in the branch network as it is rationalised and this may have a disproportionate impact on smaller towns and rural communities.

6. What are your views on the current efforts across the public sector in Scotland to respond to the recent difficulties in the financial sector in Scotland and what, if anything, needs to change in the future as the situation develops?

The public sector has already done a great deal of good work in supporting the financial services sector's success under the FiSAB partnership. The public sector should keep on investing in skills, education, planning, infrastructure, transport, business support grants and other aspects to maintain the support that has helped to build the current financial services sector in Scotland, and continues to attract large scale employers like Tesco to locate their businesses in Scotland. Investment in these areas will also bear dividend for wider business and society beyond financial services.

The Scottish Government should also consider whether there are currently, or could be created, any unique features of the Scottish legal system which might make the Scottish market a more desirable jurisdiction for financial services. An example of this is in relation to Family Limited Partnerships where a key benefit flows from the Scottish legal system giving separate legal personality to Scottish partnerships. These structures have been used to good effect to create a beneficial tax outcome for high net worth individuals across the UK and Scotland in particular. It seems quite possible that other benefits could be created under Scots law, for example in the areas of property law and other rules relating to security which might facilitate the taking of security to allow lower cost funding north of the border.

Steps could also be taken to incentivise and encourage the creation of more world class "boutique" firms such as Martin Currie and Baillie Gifford in the asset management sector, banks such as Scottish Widows Bank and Standard Life Bank and specialist professional support firms which offer consultancy and financial support to the financial services industry on a UK wide basis.

In the Highlands and Islands and south of Scotland and the establishment of green data centres has the potential to attract financial and business services functions to the areas.

Finally, financial services is one of the most heavily regulated business sectors in the country, yet the tools given to regulators failed to prevent the crisis. The UK Government must make sure that regulatory structures and processes are fit for purpose, protect consumers and markets, but at the same time allow financial services to compete in the global market by innovating and taking properly measured risks.

7. Has Scotland's reputation as a global financial services centre been detrimentally affected by the global crisis and has this been to any greater extent than the problems felt in other financial centres?

The reputation of financial services has suffered across the world, but Scotland has not been affected more than any other financial centre. We must also remember that unlike the Icelandic banks, our institutions that had to be supported by the government did not have a business model based on huge in-flows of foreign capital.

Every one of our competitor countries or locations has suffered problems and reputational damage but we will work through this to restore confidence. Despite the banking and building society problems other parts of Scottish financial services such as insurance and asset finance continue to perform well.

There are already indications that the Scottish banking market is bouncing back swiftly and robustly and it seems likely that in 3-5 years from now we will again see an extremely strong banking sector based in Scotland, with significant decision making powers in Scotland and possibly new banks here which were not here before.

8. How should Scotland differentiate itself and promote itself as a financial services centre in the future and what steps are being taken by our competitors in this respect?

Scotland needs to consider and respond to new national and international regulation as quickly as possible to position itself at the forefront of the new international financial services industry that is emerging. This means interpreting and implementing change ahead of competitors.

As stated above, the Scottish Government should continue with its successful efforts to encourage more banks and financial services businesses to start up and headquarter in Scotland.

The combination of Scotland's high skills levels and customer service, with a relatively low cost base must be the key messages to potential inward investors.

Tighter regulations for banks may require the recruitment of staff with the appropriate expertise to address such issues and Scotland could specifically try to develop and attract these skills.

9. How can we ensure that the Scottish financial sector continues to retain a global perspective and does not retreat into a purely localised lending regime?

Banks all over the world have retrenched to their local markets as a result of the crisis. However, Scotland's financial services sector still has significant international operations and exposure, and there is little danger of it losing its 'global perspective'.

10. Why are "new" banks choosing to establish themselves in Scotland, what is it that is particularly attractive and how can we build on this and attract additional investment into Scotland?

Inward investment incentives, staffing and head office costs and most importantly, the availability of senior skilled banking staff and management, with a real readiness to join up and support new banking operations, are all reasons why Scotland - and Edinburgh in particular - is attractive for new banks.

Consideration should be given to the question of whether incentives and support could be developed by the Scottish Government and its agencies to support new "boutique" banks and asset management companies with a view to their success on a UK and international basis from Scottish headquarters.

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