SCOTTISH INDEPENDENCE: IMPLICATIONS FOR FINANCIAL SERVICES

29 April 2021 | UK
Legal Briefings – By **Dorothy Livingston**

Scottish independence from the United Kingdom is the over-riding policy imperative of the Scottish National Party (SNP). There are many hurdles to achieving this goal, but with the polls indicating a likely majority in the Scottish elections for the SNP (or for the SNP together with like-minded parties, the Green Party and Alba), this must be a medium term risk which financial services businesses need to bear in mind, particularly those headquartered in Scotland.

KEY CONSIDERATIONS

Financial businesses will need to consider a number of factors in their future planning, many of which have uncertain outcomes:

Will it happen at all and, if so, when?

This cannot be known, even after the expected election result, but the risk is serious enough to justify contingency planning.

What will the regulatory regime be?

This depends on whether Scotland would leave the UK for a period in the wilderness before it can join the EU or EFTA/EEA. In the event of any significant period before either of these solutions is possible, and, in any event, to prepare for membership of one of those groupings, Scotland would need to establish its own regulatory system, and Scottish institutions will be regulated primarily locally so long as Scotland is not tied into supervision by the European authorities - the European Banking Authority (EBA) and the European Securities and Markets Authority (ESMA) (both based in Paris), the European Central Bank (ECB) and the European Insurance and Occupational Pensions Authority (EIOPA), both based in Frankfurt.

The report of the Sustainable Growth Commission (**SGC**) in 2018 provides the best indication of the thinking on how transition to independence would be managed. The SGC state that current UK legislation would be adapted in Scotland for use by its own authorities. At present, this would be a suitable basis for adapting to EU rules in due course, but the longer the period between the UK leaving the EU and Scotland being in a position to adopt its own rules and to apply for membership of the EU or EFTA/EEA, the greater adjustment would be needed to reverse any divergence between UK and EU rules. In addition, the UK model is designed for a G7 economy that contains one of the world's major international financial hubs. For a small country like Scotland the burden of regulation on the UK model would be quite high: the SGC contemplate having just 2 regulators, the Scottish Central Bank (SCB) and the Scottish financial services regulator with the combined powers of the PRA and FCA in the UK, also responsible for insurance regulation. Finally, Scotland will need to decide on the guarantees that it offers to depositors with Scottish banks in a scheme equivalent to the FSCS. The SGC suggest this would apply only to ring-fenced banks serving Scottish customer and not to their parent entities or investment bank sister companies wherever these may be established. It says nothing about whether the scheme would apply to other types of financial service providers. It is therefore not clear whether this would initially offer equivalent protection to the European minimum or have the same scope as the FSCS. This implicitly recognises that the size of the Scottish economy and of the financial sector which would fund the Scottish successor of the FSCS would not be enough to enable Scotland to stand behind the international business of any bank or other financial institution operating in Scotland, including their traditional business with customers in England and Wales.

Financial businesses could therefore be expected to face a series of regulatory changes over time as Scotland settled into its new status and those with the majority of their business outside Scotland would need to consider whether structural changes were needed.

In addition, there is a slight risk that Scottish institutions might in the short term face even greater obstacles to trading abroad than do English headquartered financial businesses, since they may not even have the rights of institutions supervised by members of the World Trade Organisation (WTO) and the new Scottish regime would need to be studied carefully before the EU could consider any grant of equivalence. In addition, Scottish data protection laws will need to be reconsidered by the EU for equivalence status.

Standard Life plc 2013 Annual Report and Accounts (published in 2014):
We have been based in Scotland for 189 years and we are very proud of our heritage. Scotland has been a good place from which to run our business and to compete around the world. We very much hope that this can continue. But if anything were to threaten this, we will take whatever action we consider necessary – including transferring parts of our operations from Scotland – in order to ensure continuity and to protect the interests of our stakeholders. We will continue to seek further clarity from politicians on both sides of the debate, so that we can reach an informed view on what constitutional change may mean for our customers, our business and our shareholders.
Chief Executive's Report: At the time of publishing this report (February 2014), we believe a number of material issues remain uncertain. These include:

- The currency that an independent Scotland would use
- Whether agreement and ratification of an independent Scotland's membership to the European Union would be achieved by the target date (currently 24 March 2016)
- The shape and role of the monetary system
- The arrangements for financial services regulation and consumer protection in an independent Scotland
- The approach to individual taxation, especially around savings and pensions, as a consequence of any constitutional change.

We will continue to seek clarity on these matters, but uncertainty is likely to remain. In view of this, there are steps we will take based on our analysis of the risks. For example, we have started work to establish additional registered companies to operate outside Scotland, into which we could transfer parts of our operations if it was necessary to do so. This is a precautionary measure to ensure continuity of our businesses' competitive position and to protect the interests of our stakeholders. As Chief Executive, my commitment is whatever happens, we will continue to serve the needs of our customers and maintain our competitive position.

The Royal Bank of Scotland Group plc 2013 Annual Report and Accounts (published in 2014):
RBSG and the Royal Bank, its principal operating subsidiary, are both headquartered and incorporated in Scotland. The Scottish Government is holding a referendum in September 2014 on the question of Scottish independence from the UK. Although the outcome of such referendum is uncertain, subject to any mitigating factors, the uncertainties resulting from an affirmative vote in favour of independence would be likely to significantly impact the Group's credit ratings and could also impact the fiscal, monetary, legal and regulatory landscape to which the Group is subject.

- Were Scotland to become independent, it may also affect Scotland's status in the EU.
- The occurrence of any of the impacts above could significantly impact the Group's costs and would have a material adverse effect on the Group's business, financial condition, results of operations and prospects.

NatWest Group plc (formerly the Royal Bank of Scotland Group plc) 2020 Report and Accounts (published 2021):
NatWest Group faces political uncertainty in Scotland, as a result of a possible second Scottish independence referendum.
Independence may adversely impact NatWest Group with NatWest Group plc and other NatWest Group entities (including NWM Plc) being incorporated and/or headquartered in Scotland. Any changes to Scotland's relationship with the UK or the EU (as an indirect result of Brexit or other developments) would impact the environment in which NatWest Group and its subsidiaries operate, and may require further changes to NatWest Group's structure, independently or in conjunction with other mandatory or strategic structural and organisational changes which could adversely impact NatWest Group.
Q1 2021 Interim Management Statement (29 April 2021)
In the Management Presentation following the release of NatWest Group plc's Q1 2021 Interim Management Statement, the Chief Executive Officer Alison Rose said:
"In the event that there was independence for Scotland our balance sheet would be too big for an independent Scottish economy. And so we would move our registered headquarters, in the event of independence, to London."
The Interim Management Statement showed that NatWest Group plc's total assets amounted to £769.8bn on 31 March 2021. This is 4.3 times higher than Scotland's GDP (including geographic share of North Sea revenues) for the period April 2019 to March 2020.

What will Scotland's currency be and will it be tied in any way to another currency?

At the time of the 2014 referendum, the SNP intended to continue use of sterling, but they have now changed their policy to one of adopting an independent currency as soon as practicable: see our briefing on Scottish independence and currency: Choices, issues and implications. There are, however, options to tie that currency in a fixed or narrowly fluctuating band to one of the major currencies that affect the Scottish economy: sterling, the euro, or even the US Dollar. England is Scotland's largest trading partner and it would take time to change this position, making sterling a natural currency to align with. If, however, Scotland were to apply to join the EU, it would have to commit to adopting the euro as its national currency when its economy was sufficiently aligned and robust, so making this the currency of choice for alignment. Finally oil and gas are traded in US Dollars, but for reasons discussed below, this would likely be a declining share of national revenue, and there would be no longer term synergies, so this would seem an unlikely choice.

Another factor arising on achieving independence and, certainly, on adopting its own currency, is the effect on the credit rating of Scotland and, onward impact on the ratings of institutions and businesses exposed heavily to that currency. This would also be affected by fiscal and economic factors affecting Scotland.

What will the state of the Scottish economy and its taxation system be?

It is expected that Scotland, if it became independent, would receive the assets present in its territory and be required to issue debt to replace an appropriate share of the UK national debt. At the moment, Scotland has higher expenditure per head of population than England and Wales and generates less direct tax income per head of population than England and Wales, although the SGC notes that this impression is distorted by the much higher affluence of London and the South East, as compared with the regions. Excluding London and the South-East, Scotland compares well with other English regions. The question how an independent Scotland would manage without access to the revenues generated in London and the South East, would affect the taxation profile for Scottish businesses and Scottish residents.

Although Scotland would be expected to retain all the benefits of oil and gas production in Scottish territorial waters, it is not clear whether any adjustment relative to the historic use of these revenues will be made. Going forward, climate change policies and the state of reserves mean that this would be a declining asset. SNP policy is to treat these revenues as a sovereign wealth fund, rather than to use them in day to day fiscal management: a policy that could indicate a period of considerable fiscal stringency while the economy sought to adapt to independent life, especially in the aftermath of the COVID pandemic.

What will the barriers to trade be for Scottish based businesses?

Closely linked to the macro-economic picture will be the question how quickly Scotland could achieve a tariff-free trading relationship with the EU or fully join the EU/EEA single market, how long before its exports could benefit from free trade relationships with other traditional trading partners and how long it would be before Scotland would be treated as a member of the WTO. Important Scottish exports, such as whiskey, could be adversely affected if these issues take many years to resolve: see our briefing on Scottish independence: The consequences for trade.

It is probably fair to expect that independence arrangements would include a new trade treaty with the continuing United Kingdom ensuring that trade with England and Wales would remain tariff-free: although how far European ambitions would prevent Scotland remaining part of the UK single market without frontier controls at the English/Scottish border remains to be seen. It also seems likely that an independent Scotland would be permitted to remain in the historic common travel zone between the UK and the Republic of Ireland, so preserving free movement of labour to the same extent as currently enjoyed.

These are important issues that will determine how far Scotland can retain or attract major businesses, which are key customers for financial businesses operating in Scotland.

How should each financial business best organise to serve the needs of customers?

This is the point which all the other questions lead to, but also requires Scottish headquartered financial businesses to consider three key considerations:

- What are the advantages and disadvantages of running all or parts of the business from an independent Scotland?
- Where is our main customer base?
- What will our investors want?

IMPORTANCE OF CUSTOMER BASE

Since the eighteenth century, after Scotland joined the United Kingdom following the Act of Union in 1707, Scotland has been the home to a range of successful financial businesses serving customers in the UK and further afield. Edinburgh has a strong reputation as a financial centre, with leading Scottish institutions serving the whole UK and other markets.

These businesses have benefitted from free access to the whole population and business base of the UK as customers on the same terms as institutions headquartered south of the border and from the status of the UK as a whole as a leading world economy, with an experienced financial regulator able to manage a major financial crisis and a central bank able to support financial businesses through times of trouble.

In the 2009 financial crisis, two Scottish businesses required major UK Government intervention to keep them afloat, Royal Bank of Scotland and Lloyds Banking Group (which, as well as being headed by a Scottish registered company, had recently acquired HBOS plc, which included Bank of Scotland, a major Scottish bank). It is difficult to see that had Scotland been an independent country at that time, it could have supported such large institutions. Their rescue can be compared with the fate of some Irish and Cypriot banks that were wound up in that crisis and the partial loss of deposits experienced by customers of one Cypriot bank that did survive.

Back in 2014, some of these institutions and other financial institutions recognised that they would need to consider moving at least parts of their business out of Scotland (see box above) in the event that Scotland were to become independent. Many of those considerations remain relevant: see comment on possible need for structural change in the 2020 accounts of NatWest Group PLC (formerly the Royal Bank of Scotland Group plc). The SGC, in suggesting only customers of ring-fenced banks serving the Scottish market would benefit from the Scottish successor to FSCS, effectively is telling banks to take their other business elsewhere, which may mean moving out of Scotland not just business with customers in the rest of the UK, but international and investment business generally. This may make a change of headquarters and/or the establishment of the group holding company outside Scotland worthy of serious consideration.

Of course, some of the dynamics have changed. In 2014, institutions did not want to find themselves classed as outside the EU, but now that the UK has left the EU, this advantage of moving headquarters to England would no longer apply, but, equally, those with significant business in the EU, will already have made arrangements for continuation of EU business from hubs in Ireland or continental Europe. Given the likely period of uncertainty about Scotland's status in relation to the EU, there would be no benefit in considering the relative merits of managing EU business from Scotland or from a current EU hub, until Scotland has achieved a stable relationship with the EU which gives its financial institutions passporting rights in the EEA as a whole. This may take several years.

If an institution decides to move its Group holding company and/or subsidiaries trading outside Scotland to another jurisdiction, in choosing whether to headquarter in England or an EU country, a financial institution would consider access to capital, the location of their customer base and how their current business structure could be best adapted.

The need to attract and retain customers and to raise capital are likely to be key.

- Simply because the population of Scotland is less than 10% of the population in England (5,463,300 as compared with 56,286, 961 according to the [Office for National Statistics for 2019], published 24 June 2020) and Wales and Northern Ireland are both considerably smaller than Scotland, it follows that most of the UK customers of major (and some smaller) Scottish financial institutions are also in England – in some cases, this will be the majority of all customers. English customers and other UK customers, if they stay with a Scottish based institution after independence, would be at risk of exposure to divergent tax treatment affected by the state of the Scottish economy and the policies of an independent Scottish government. They may well wish to deal with a company established in the continuing UK, rather than in Scotland, so as to avoid this risk. While taxes in the continuing UK would also be subject to evolution, undoubtedly the risks would be different.

- In addition, businesses will be concerned about access to capital. This may well be perceived to be easier for a business headquartered in a country with a major international financial centre. For investors in a financial business, the robustness and size of the economy which provides overall financial regulation is also of considerable importance, as discussed above, as well as the tax treatment of dividends and interest payable to investors. These considerations will apply, even where a group is already organised so that most English customers deal with an English trading subsidiary.

METHODOLOGY

Reorganisation to create a new top company for a group is a relatively well trodden path, though not without costs. This sort of change could be effected ahead of independence, taking account of the common company law (Companies Act 2006) and financial regulation currently applying in the UK as a whole. It is simpler to effect if the group holding company is not also a trading company with a banking, insurance or other financial services business, but can be achieved even in those cases. Where Scottish and English businesses already operate in separate legal entities, the immediate changes would probably be almost imperceptible, but in other cases customers might be encouraged or even required to change their business to a different member of the group. Scottish registered subsidiaries carrying out Scottish and perhaps some third country business would seem likely to be retained and to hold assets located in Scotland.

Such changes do not mean that current employment levels in Scotland for these businesses would necessarily change: that would depend on factors such as the ease of holding records etc. for members of the group based in England and Wales and relating to customers in England and Wales in Scotland and on the overall costs of providing these services in Scotland or elsewhere, factors that are in any event reviewed from time to time. However, once a business is headquartered out of Scotland, the focus of its attention may change, along with its centre of management.

WOULD THIS MEAN THE END OF EDINBURGH AS A MAJOR FINANCIAL CENTRE?

It is far too pessimistic to say that this will be the case. The answer would, however, lie very much with the government of an independent Scotland in the early years of independence and in the way that it manages the regulation and taxation of financial businesses and their customers, as well as on how quickly access to the EEA single market might be obtained.

More on scottish independence

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

DOROTHY LIVINGSTON
CONSULTANT, LONDON

NISH DISSANAYAKE
PARTNER, LONDON

+44 20 7466 2365

CLIVE CUNNINGHAM
PARTNER, LONDON

BARNABY HINNIGAN
PARTNER, LONDON

+44 20 7466 2061
Dorothy.Livingston@hsf.com

Nish.Dissanayake@hsf.com

+44 20 7466 2278
Clive.Cunningham@hsf.com

+44 20 7466 2816
Barnaby.Hinnigan@hsf.com

LEGAL NOTICE