THE DAVID HUME INSTITUTE

Scottish Independence: Issues and Questions
Regulation, Supervision, Lender of Last Resort and Crisis Management

Brian Quinn

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Foreword

During the course of 2012 and 2013 the David Hume Institute, in partnership with the Department of Governance at the University of Edinburgh, organised four ‘conversations’ on topics related to possible constitutional change in Scotland. These were funded in part by the Economic and Social Research Council and each took the form of commissioned research papers, a round table with key interested parties and then an open seminar involving inter alia the authors of the papers – and with those papers published for the seminars.

The first conversation was on macro-economic policy issues, but including the complex world of financial sector oversight and regulation. We were delighted that Professor Brian Quinn, for many years at the Bank of England but now an Honorary Professor at Glasgow University, agreed to contribute a research paper and to participate in the round table and the seminar. His detailed understanding of so many of the key issues really added value to our debate and his paper has been widely quoted and read.

Given this past contribution, I was really pleased when Brian indicated that he was preparing an updated and expanded version of his paper and I immediately agreed to publish this also as a DHI Hume Occasional Paper. The issues he covers in both his papers are highly relevant to the continuing and crucial debate, as we come to within around a year of the date of the independence referendum.

This new paper covers a wide canvas, from issues related to the choice of currency for an independent Scotland to financial regulation, bank supervision and crisis management. A glance at his CV shows how well placed Brian is to provide informed commentary in all these areas.

In this paper Brian Quinn first considers the post independence options so far as a currency is concerned, and thereafter assumes that ‘an independent Scottish Government would seek to negotiate a sterling currency union with the UK Government and UK Parliament’; but also ‘with the intention of continuing to use the Bank of England as the supervisory authority for Scottish incorporated financial institutions and for maintaining financial stability more generally’. He further notes that the recent – and continuing – financial crisis has demonstrated the central importance of ensuring that regulation, crisis management and supervision function effectively.

He then proceeds to provide an assessment of how this all might work. He takes account of the report of the Fiscal Commission Working Group, but notes that this is – probably inevitably at this stage - ‘mainly high-level and non-specific’ in some areas. He examines more of that detail and those specifics.

The conclusion of this examination is that many of the questions raised should be capable of being answered via negotiation, but others, crucially, ‘appear to be more fundamental’. The difficulty of the Bank of England ‘serving two masters’ would be accentuated as economic policies and economic structures diverged. As Brian neatly summarises the story; ‘Trying to stand astride two horses heading in diverging directions could lead, sooner or later, to an expensive accident’. Clearly he sees critical issues of concern.

As ever we at the DHI will not offer our views on the points raised in this paper. We welcome this contribution to a crucial discussion, where the need for informed and transparent comment is clear. We are delighted to make the paper available and hope and expect that this will add value as the debate on macro-economic management and financial supervision under varying forms of constitutional structure continues.

Jeremy Peat

Director

David Hume Institute

August 2013

About the Author

Brian Quinn, who was born and educated in Glasgow, was Head of Banking Supervision (1982-1988) and Executive Director of Supervision and Surveillance (1988-1996) at the Bank of England; and acted as Deputy Governor (1995). He was a member of the Basel committee of Banking Supervisors (1983–1993) and represented the UK in negotiations in Brussels on EU Directives on banking supervision and payments systems. He was the first Chairman of the Committee of European Banking Supervisors.

After retiring from the Bank of England he was appointed advisor to the Monetary Authority of Singapore and to the Central Banks of Chile, Colombia, Venezuela and Malaysia on banking supervisions and crisis management. He also worked with the International Monetary Fund, the World Bank and McKinsey as a consultant on financial supervision in several countries, including Indonesia, China and Turkey. From 2006 to 2011 he was a non-executive director of the Qatar Financial Centre Regulatory Authority.

He is currently Honorary Professor of Economics and Finance at Glasgow University, where he teaches a graduate course in Financial Stability and Growth and is a member of the Glasgow University Business School Strategic Advisory Board. He is a Fellow of the Chartered Institute of Bankers in Scotland. Since 2009 he has been a member of the UEFA Club Financial Control Body.

Executive Summary

This paper examines the issues that would arise in the areas of financial regulation, supervision and crisis management should Scotland become an independent sovereign state following the referendum next year.

It looks at the options on the choice of currency from the standpoint of financial stability and, taking account of the complexity and uncertainty surrounding Scotland's membership of the European Union, concludes that negotiating membership of a sterling currency zone would be the preferred choice. It puts this together with the current Scottish Government's wish to continue to use the Bank of England as its supervisory authority post-independence and asks whether this scenario is feasible.

The paper sets out the scope of the task facing the Bank of England in these circumstances and points out the problems of both principle and practice in carrying out its supervisory functions. A shared system of supervision would encounter difficulties at the level of both individual financial institutions and the financial system with, in particular, serious weaknesses in governance and accountability. As an independent Scottish Government adopted economic policies which differed from those of the Westminster Government, these flaws would increase in severity.

Given these uncertainties and concerns, it seems very likely that the Bank of England would judge Scottish financial institutions – notably its banks – to have become riskier and apply higher regulatory requirements in order to protect depositors and investors.

The common UK financial regulations that currently follow from the negotiations on EU Directives could give way to differences between those adopted by the two countries as their economic and financial structures diverge.

The paper examines the implications of a shared system of crisis management. The clarity of responsibilities and procedures which were central objectives of the Financial Services Act 2012 would be reversed; and the crucial requirement for speed and authoritative action in the face of a systemic crisis would be jeopardised, if not lost altogether.

Estimating the cost of such a crisis to the Scottish taxpayer is now very difficult, given the changes that have been introduced, and are proposed, for banks since the current crisis occurred. Nevertheless it could still amount to a significant fraction of a post-independent Scotland's GDP. Scottish financial institutions might also face a substantial increase in their contributions to a financial compensation fund.

The Fiscal Commission Working Group appointed to advise the Scottish Government on these issues does address them, but at a high level and does not look at the complications and implications in depth. Its assumption that other UK taxpayers should share the costs of the collapse of Scottish banks does not appear to have a legitimate basis.

The paper concludes that the concept of a shared system of supervision and crisis management is seriously – perhaps fundamentally - flawed and that its weaknesses would increase during the indeterminate period of transition following independence. This, together

with the uncertainties regarding Scotland's continued use of sterling arising from its proposed membership of the EU, are likely to result in higher prudential requirements for Scottish financial institutions. In these circumstances it would not be surprising if they reconsidered their group structures and main domicile.

1. Introduction

This paper updates an earlier article in which a range of economic and financial issues was explored in the context of the debate on the case for an independent Scottish sovereign state.[1] It looks in greater depth at issues arising in the regulation and supervision of financial institutions; in the areas of Lender of Last Resort, resolution of failing financial institutions and crisis management; and takes account of a number of recent official publications, notably the Financial Services Act 2012, the publication of various memoranda of understanding between HMT Treasury, the Bank of England, the Prudential Regulatory Authority and the Financial Conduct Authority. It also refers to the report of the Fiscal Commission Working Group[2] and to recent developments in the Eurozone in these areas.

The subjects may appear narrow and technical when set beside the principal instruments of macro-economic policy – the currency, monetary policy, the exchange rate and public finances. However one positive outcome from the current ongoing financial crisis has been to illustrate the central importance of ensuring that these other areas of public policy – regulation, supervision and crisis management - function effectively. Not only is it evident that they are inextricably linked with macro-economic policies, but also that weaknesses in regulation, supervision and crisis management can greatly magnify the damage caused by errors in macro-economic policies. Indeed the effects in terms of losses of personal savings, investments and individuals' other financial assets are more direct and immediate.

In the period since the financial crisis occurred, while the framework within which financial regulation, supervision and crisis management are to be conducted has received close attention at both the national and international levels, there is still uncertainty about the real choices on these matters available to Scottish voters with the referendum on independence just over a year ahead.

As with other areas of public policy, some of these choices can be made only after the result of the referendum is decided and the precise arrangements negotiated between the rUK[3] and Scottish Governments. However, even at this stage, it is necessary at least to set out the risks and challenges entailed in moving away from a system built on long experience and the practical lessons of the immediate past, to a system the nature and implications of which are at this point unexplored. Financial institutions and financial markets prefer stability and dislike uncertainty, so they would not welcome unpredictability in the regime in which Scottish financial institutions operate post independence.

Two of the key parameters in determining financial stability for an independent Scotland are the choice of currency and the institutional framework for regulation, supervision and crisis management of its financial institutions, particularly its banks.

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[1] B. Quinn "Scottish Independence; Issues and Questions, David Home Institute, Edinburgh, November 2012. Research Paper 3/2012

[2] Fiscal Commission Working Group, First Report – Macroeconomic Framework, Scottish Government, February 2013.

[3] As in the previous paper rUK is used to indicate the rest of the UK post-independence

Although there are four options in principle for the currency, these reduce to two when considering Scotland’s particular starting position. Forming a new separate Scottish currency may be feasible, or even desirable, in the longer term once Scotland has had some experience in establishing its own macro-economic policies and the structure of the Scottish economy has adjusted to adopt the appropriate shape in response.

Even then, attempting to establish a new currency would be far from straightforward, given the current dependence of its exports on its hydro-carbon sector.

A second option would be to join the European Currency Area - the Eurozone - and adopt the Euro. The Scottish Government has announced its intention of "continuing" as a member of the European Union. This is disputed by the European Commission whose President, Manuel Barroso, has publicly expressed the view that an independent Scotland would have to apply for membership as a new entrant. This view is shared by some member states which recognise that automatic entry for Scotland would encourage the separatist movements in their own countries. There is therefore the real prospect of this issue being taken through the EU administrative and political process and the European Courts, with the resulting long delays.

More important, if the decision should go against Scotland's claim to automatic entry to the EU and it had to apply as a new member, it would be legally obliged to commit to joining the Eurozone as a condition of membership. This was confirmed recently with the admission of Croatia to the EU. In these circumstances an even longer time frame would be needed to complete the process. Any new entrant has to satisfy a number of conditions, including operating with its own currency within the Exchange Rate Mechanism for a minimum period of two years, together with documented satisfactory performance on several macro-economic measures, data on some of which could begin to be collected only once the terms of any settlement with rUK has been agreed. In any case, Scotland does not have its “own” currency and it would be unthinkable to introduce one solely for this purpose. There would also be implications for the terms of the negotiations post-independence with the UK Government (see below). In either case, a lengthy transition until the question of Scotland's currency is resolved seems certain.

Establishing a new currency in any country, whether unique to that country, or one already in use elsewhere, is an expensive and lengthy matter. All company and bank accounts have to be changed, cash machines altered, prices of goods and services re-calculated, social security payments altered, etc. The switch from 17 different currencies to the Euro took several years to organise and implement.

A third option is so-called “sterlingisation” where Scotland would retain sterling as its currency but with no role in the formation of domestic or external monetary policy. Precedents for this option are Panama and Montenegro which have adopted the $US and the Euro, respectively. It would be a strange form of independence for Scotland to have its interest rates and exchange rate determined in London, relinquishing the levers that are necessary to effect the changes in policy which the Scottish Government assert are necessary to develop its economy in a different way.

Looking at the matter from the viewpoint of the requirement for financial stability, "sterlingisation" would be no less unsatisfactory. Neither the instruments nor the timing of policy action to manage threats to financial stability would be available. Using interest rates, for example, to prevent the development of bubbles in financial assets would not be possible; and perhaps even more unsatisfactory, policy action taken in rUK to anticipate such a threat in its financial markets could run counter to the contemporary requirements of the Scottish economy.

More generally, sterlingisation would remove from a newly independent Scottish Government control over a central determinant of financial stability – an excessively loose monetary policy has been a common factor in many financial crises including, it has been argued, the current crisis.[4]

Sterlingisation would also remove – or at least seriously constrain – the ability to respond to systemic crises. Such crises usually take the form of sudden significant shortages of liquidity in the banking system; and, as in the recent crisis, shortfalls of capital – insolvency - in important banks. The classic response of the authorities in the face of a fast developing liquidity crisis is to provide the liquidity at market rates in the amounts judged necessary to arrest the contagion affecting the markets – i.e. act as Lender of Last Resort; or act as rescuer of insolvent banks by recapitalising them. To do either of these things with no capacity to create the liquidity or capital as required would involve building and retaining reserves, in sterling, to meet these contingencies. The amounts involved could be very large. The cost of recapitalising the RBS alone when it failed was more than twice the estimated GDP of an independent Scotland. That some or all of this amount may be recovered when the bank is sold back to the private sector is irrelevant: emergency liquidity and the capital necessary to stabilise systemically important banks has to be provided immediately, publicly and upfront. Scotland could aim to build its sterling reserves from current account surpluses but the consumption and investment foregone would be enormous and a significant drain on economic activity.

This leaves membership of an agreed sterling zone as much the preferred option among the currency choices. It is also the publicly declared choice of the current Scottish Government and of the Fiscal Commission Working Group which advises it. For the purposes of this paper, therefore, it is assumed that an independent Scottish Government would seek to negotiate a sterling currency union with the UK Government and UK Parliament.

The Scottish Government has stated that it is its intention to continue to use the Bank of England as the supervisory authority for Scottish incorporated financial institutions, and for maintaining financial stability generally. This statement was made without any reference to the matter of Scotland's membership of the EU, or of the Eurozone in the event that automatic membership of the EU should fail. In the latter case, these functions would transfer to the

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[4] The UK Secondary Banking Crisis. 1973-74; the UK Small Banks Crisis, 1991-93; the Latin American Debt Crisis, 1982-84; the South East Asian Financial Crisis, 1997-98; and many others.

European Central Bank and, depending on some as yet unresolved issues, to the European Commission. As with the matter of the currency, a lengthy transition period would occur.

Could such an arrangement work? What difficulties and complications might arise? Would they be manageable with goodwill and cooperation on both sides; or are some of them fundamental?

2. Regulation and Supervision – Macro and Micro-Prudential Supervision

Until the financial crisis of 2008, financial regulation and supervision were directed primarily at the safety and soundness of individual financial institutions with the objective of protecting the interests of individuals, savers, investors and policy holders (insurance, pensions, etc). That is not to say that central banks, regulatory and supervisory bodies ignored the need to protect the financial system at both the national and international levels.

The Bank of England's Lender of Last Resort function aimed to prevent problems at individual commercial banks from developing into a crisis which threatened the entire UK banking system and the economy which it served. Central banks in many countries have similar arrangements, acting both as supervisory authority and as Lender of Last Resort. In those cases where supervision of individual institutions is carried out by a separate public authority the central bank, using its balance sheet, carries out the role of Lender of Last Resort, acting in conjunction with the supervisory authority.[5]

It was assumed that maintaining the safety and soundness of individual institutions – primarily banks – would ensure the stability of the financial system. The crisis that broke in 2008 demonstrated the fallacy of that assumption and made clear the necessity of empowering regulators and supervisors to deal with problems at the levels of both individual institutions and the financial system as a whole. This is recognised in the reforms introduced in the UK Financial Services Act 2012: the Bank of England has explicit responsibility for supervising both individual banks and for the UK financial system.[6]

At present there is little difficulty in knowing where the boundaries of the UK system lie. There is a recognisable UK financial system. Financial institutions incorporated in England, Scotland, Wales and Northern Ireland form that system and do so in a complementary way. The paper published recently by the Treasury contained data showing that cross-border business conducted by Scottish and English Financial institutions in both directions is very substantial.[7] The two principal Scottish banking groups have sizeable subsidiary and branch operations south of the border and English incorporated banks also have operating entities in Scotland, albeit on a relatively smaller scale than their Scottish counterparts. The Scottish banks are members of the UK clearing, settlements and payments systems, are members of the British Bankers Association and other bodies which not only draw their membership from

[5] This does not always work smoothly. It has been argued that one contributory factor to the slow response to the evolving crisis in the UK was a lack of effective communication between the Bank of England and the FSA.

[6] In the terminology, micro-supervision and macro-supervision, respectively.

[7] HM government, Scotland Analysis, Financial Services and Banking, May 2013.

across the UK, but also represent their interests in discussions and negotiations affecting regulation, taxation and many other matters.

The Bank of England has published details of how it will organise itself to carry out its work as the macro-prudential authority. A Financial Policy Committee, chaired by the Governor and including the Head of the Prudential Regulatory Authority (PRA) and the Deputy Governor for Financial Stability will monitor activity in UK and international markets and devise policies which will be implemented by the PRA at the level of individual firms. The roles of the Bank – via the PRA - and of the Financial Policy Committee as micro-prudential and macro-prudential supervisors are clear enough while the UK financial system operates as it does at present. However, important questions arise on how they might function if Scotland became a separate, independent sovereign state.

At present there is no Scottish financial system as such. Scottish incorporated banks, insurance companies, asset management firms, etc are integral parts of the UK system; all would have been threatened, more or less directly, if the recent crisis had not been dealt with by the relevant authorities: the UK Government and the Bank of England.

Both the Royal Bank of Scotland group and Lloyds Banking Group, which includes the Bank of Scotland, were deemed “too big to fail” not only, or even primarily, because of size of their customer base of depositors and borrowers, but because of their central role in the UK financial system. Their failure would have created very serious problems – perhaps the complete collapse – of the financial markets in the UK and the rupture of the UK financial infrastructure.

Immediately after independence and for so long as the larger Scottish banks play their current role in the UK system,[8] could they be supervised by the Bank of England whose responsibility it is to safeguard the stability of the UK financial system?

Is this a sustainable arrangement? There are issues of both principle and of practice that need to be addressed. Regulators and supervisors are public servants and employees of the state whose ultimate job it is to prevent taxpayers of that state from loss. Failure to do so results in their being held to account by Parliament (or its equivalent). If Scotland were to become a separate sovereign state, it is difficult to see how the supervisors employed by the Bank of England could be held accountable to the taxpayers (or their elected representatives) of another state. There is no precedent for such a dual role. The objective of bringing clarity to the responsibility for supervision and financial stability, which is a key – perhaps the central part - of the foundations of the Finance Act 2012, and the source of much of the controversy in the moves to a European Banking Union, would come into question.

One hypothetical solution might be for the Scottish Parliament to formally outsource the supervision of its financial institutions to the Bank of England under contract, with a separate section dedicated to Scottish institutions. The legal implications for the Bank and its employees are unclear. As rUK public officials the relevant staff of the Bank could not be

[8] These banks have been understandably reluctant to declare their intentions should the referendum go in favour of independence but they will no doubt be considering

held accountable to the Scottish Parliament. The Bank of England has refused to permit its supervisory staff even to appear before Congressional Committees in the US in the past on constitutional grounds. Public officials cannot be servants of two separate sovereign states. But inability to hold supervisors to account would amount to an unacceptable gap in governance so far as the new Scottish Parliament is concerned.

This proposal would also ignore the reality of supervisory work. The information supplied to bank supervisors to enable them to carry out their responsibilities includes access to data and knowledge about the business of corporations, individuals and official institutions that is confidential and protected by statute. For example, banks report their largest exposures, both loans and liabilities, to individual customers by amount every month. This information may be disclosed to other supervisors, including foreign supervisors, under certain conditions, but there could be legal and political problems if information on Scottish borrowers or depositors was supplied to supervisors in another jurisdiction without prior approval by a Scottish official body of some kind. However, the creation of such a body for this or any other similar purpose, would create other issues (see below).

Supervisors do not work in hermetically sealed boxes labelled with the particular institutions they supervise. They work together, exchange views, draw on one another's work and experience and frequently move jobs within the organisation. Information flows in a more or less informal way between them and colleagues in other parts of the Central Bank, including the financial markets areas. Any change in the operations of the financial markets area which could affect the prudential requirements for banks, such as a significant change in the Bank's activities in the gilt-edged or Treasury Bill markets would be discussed beforehand with the bank supervisors; and vice-versa. These and other changes could be influenced, or even determined, by changes or developments in rUK Government policies.

In the short-term some of the particular risks which might arise from a dual capacity role for the Bank as macro and micro prudential supervisor may be manageable with goodwill and ingenuity. However, the fundamental issues of governance and accountability would remain. As an independent Scottish Government sought to adopt different macro-economic policies to generate what it sees as currently unexplored opportunities for economic growth, these risks would surely increase. But even in the very short-term confusion could occur. In supervision complexity itself is a risk waiting to translate into practical problems.

3. The Fiscal Commission Working Group Report - Supervision

The report of the Fiscal Commission Working Group is fairly high level on matters of supervision. It proposes that Scotland establish one or more independent competent authorities to oversee financial regulation to help ensure that the economy and tax-payers are "never again" forced to step in and bail out financial institutions.[9]

First, even if the various reforms in banking supervision and regulation introduced since the financial crisis do reduce the frequency and costs of bank failures, they will not prevent the collapse of banks and other financial institutions in the future. These reforms address weaknesses in the financial system and in financial institutions that were not foreseen - and possibly not foreseeable - in the years preceding the crisis. In that crisis market developments which had appeared to reduce and spread systemic risks – and which were almost universally welcomed - ran ahead of supervisors' capacity to prevent the consequential problems at both the level of the individual bank and at the level of the financial system. Whether it is in the form of fraud, operating failure or imprudent behaviour, banks will fail and systems will be destabilised. This is acknowledged in the provisions for depositor and investor compensation, and in the changes in the arrangements for resolving failed banks.

Secondly, establishing one or more independent competent supervisory authority could take several years. There are many examples of experienced officials being hired by countries aiming to build new financial systems. The Bank of England and other supervisory authorities from mature financial centres have seconded supervisors to other, mostly developing, countries in the past. However attracting experienced and competent supervisors to work in an organisation whose powers and responsibilities had not been clearly defined would be difficult. The report of the FCWG offers little in the way of exploring the detailed problems in operating a shared supervisory authority, commenting at the level of design options and alternative frameworks.

The report of the FCWG also proposes that key elements of prudential regulation (micro and macro) be discharged on a consistent basis across the Sterling Zone. However there is no specification of what these key elements are, what is meant by doing this on a consistent basis, or what the challenges in achieving consistency entails.

The prudential requirements for individual banks are set in the UK on a bank-by-bank basis: their capital adequacy requirements, liquidity ratios, concentration limits, etc are set by Bank officials to reflect the risk profile of each bank. Any change in the risk profile of the bank brings a re-assessment of the suitability of the requirements and, if appropriate, a change in one or more of them. The decisions are taken by the executive, not by the members of the Court of the Bank, nor by the members of the Financial Policy Committee. The methodology is consistent - but decisions are always case by case. If Scotland were to become an independent sovereign state with economic and financial policies materially different from those in the rUK over time, it would be necessary for the Bank, through the PRA, to reassess

[9] Fiscal Commission Working Group, First Report, page 181

the prudential requirements applying to each Scottish financial institution. Should this lead to a judgement that the risk profile of those institutions had changed for example through changes in fiscal position or competition policy, the prudential requirements could be altered. So long as any such decisions were taken by the Bank of England (PRA) in accordance with a common process, this should meet no objections from the Scottish authorities. However each case comes down to a matter of judgement regarding the particular circumstances in play. There is usually ground for disagreement. How would such disputes be resolved?

Less straightforward is the proposal that systematically important institutions currently operating across a Sterling Zone would be regulated and supervised at the micro-prudential level by the Bank on behalf of a Scottish regulator or by a Scottish Monetary Institute working in partnership with the Bank. These two models raise a number of questions. What would be the powers of the Scottish regulator or the Scottish Monetary Institute? What would a partnership role entail? Who would decide which institutions were systemically important and which were not? How would non-systemically important institutions be supervised? None of these questions is asked or answered in the FCWG report.

The FCWG also proposes that macro-regulation also be aligned, but does not set out how that might be done. It adds to the uncertainty by suggesting that in future years there might be scope for exploring opportunities for a "spatial variation" of such policy[10] within the Sterling Zone, a concept that needs elaboration. Financial markets and foreign supervisors would not be content to trust that the new arrangements contained in the Financial Act 2012 to simplify and clarify how systemic risk in the UK is managed would not be compromised.

One solution that has been suggested is that there be Scottish representatives appointed to the Financial Policy Committee of the Bank of England (and to the Monetary Policy Committee).This would certainly take the interests of the Scottish Government and financial institutions into account directly. There are, however, two difficulties with the suggestion. First, the Scottish representatives could have access to information that came from rUK Government official and other confidential sources, such as proposed changes in rUK taxation or the position of foreign owned banks with operations only in London. Secondly, unless the Scottish and rUK representatives were equal in number or in voting power, they would be in a minority on policy issues affecting the interests of both UK and Scottish institutions, placing them in a position of having responsibility without the necessary powers.

4. Issues in Micro-Supervision

Under the Financial Services Act 2012, the Bank of England has sole authority in the UK to authorise institutions to offer financial products and services in the UK. The criteria for offering such products as deposits, insurance and investment products are set by the Prudential Regulatory Authority (PRA), a subsidiary of the Bank. The Financial Conduct Authority (FCA), a separate institution from the bank, is responsible for ensuring that

[10] Fiscal Commission Working Group, First Report, page 144.

financial markets function effectively and that consumers of financial products and services are treated fairly.

The PRA operates at the level of the individual firm or group, setting the minimum prudential requirements; and amending them if its assessment of the risk profile of the institution changes. For operational supervisory purposes the risk profile is captured partly by the risk weights accorded to the products and services reported to the PRA in the periodic prudential statistical returns. For more sophisticated and diverse firms, the institutions' own risk models may be accepted by the PRA as a means of setting the capital and liquidity ratios it must maintain.

How would the PRA assess the risk profile of Scottish banks (and other financial institutions) post-independence? Could it judge that the move to independence itself would result in their becoming riskier? That possibility cannot be dismissed and, indeed, seems even more likely if Scotland should move to join the Eurozone, whether voluntarily or by treaty obligation. It is the Scottish Government's stated intention to develop its economy through policies and actions that differ from what they would be if Scotland remained a member of the UK either by choice as a member of the sterling currency zone, or in order to qualify for membership of the Eurozone. In either case, it would be embarking on a road not previously travelled and one diverging from that chosen by the rUK Government. Until a record of good financial and economic performance had been achieved, this could represent a new and riskier environment for Scottish banks and financial institutions. A successful application for entry to the EU, should that be necessary, would probably mean that the process of meeting the conditions for membership of the Eurozone would have to begin early in the transition period; but it is very likely that a newly independent Scotland would adopt different economic policies anyway fairly promptly after a successful referendum vote.

In these circumstances the PRA would have to reassess the risk profiles of banks and financial institutions incorporated in Scotland, treating them as other foreign banks. In that reassessment account would have to taken of the capacity of the new Scottish Government to provide financial support should the need arise (see below, Section 8); the more divergent the positions of the two governments in the post -independence negotiations on matters of substance, the greater the presumption that the PRA would look carefully at any implications for the riskiness of Scottish financial institutions. This would not be evidence of threatening behaviour but of the professional action required to protect rUK depositors and investors.

Another potential source of difficulty concerns the permissions the PRA gives to financial companies to change their business plans. In particular, PRA permission is needed to introduce new products or services on any significant scale, to open overseas branches or subsidiaries, to change the ownership structure or to acquire or dispose of a business owned and operated by a third party. These requirements would of course also apply to rUK firms but, given the central role played by financial institutions in a country's economic development, the refusal of the PRA to grant such permissions to Scotland's financial groups has obvious potential for political dispute. Again, how would such disputes be resolved?

5. Regulation of Financial Institutions

For the UK, and presumably for an independent Scotland, (if and when it was admitted to the EU), the great majority of financial regulations are determined by the European Union – negotiated in Brussels by national governments, the European Commission and the European Parliament. As pointed out in the earlier paper, the great majority of directives which emerge from these negotiations are general in nature, leaving translation into domestic law to national Parliaments. In a post-independence Scotland an obvious issue arises: would there be separate regulations for Scottish financial institutions; or, given the continuing existence of a UK financial system, would common regulations have to be agreed between the rUK and Scottish Parliaments? If it were the former, there would be the prospect of differences developing between the prudential requirements depending on the country of incorporation of the institution – a further source of uncertainty for the functioning of a continuing UK financial system. If the latter, what role would the Bank occupy as a supervisory authority? Could it act as advisor to both the rUK and Scottish Parliaments, as the directives were translated into national laws?

Questions also arise about representation in formal negotiations on European Directives and Basel agreements. In Brussels Scotland would presumably participate separately at ministerial level, and possibly at the level of senior official, including the permanent ambassador to the Commission. Below this level questions arise. What finally emerges as a directive is the product of discussions between representatives of each country and the Commission about how a Directive could affect the markets and institutions in each member country. The final shape of the national regulations in turn owes a great deal to detailed knowledge of local markets and institutions; and to internal discussions between officials and trade organisations such as the British Bankers Association, the Association of British Insurers etc. At present the framework and interests of UK institutions and the regulators are aligned – not identical, but aligned. This might no longer apply post-independence; such alignment pre-supposes common or shared objectives.

In the short term, in many matters it is unlikely that serious differences would arise between the objectives of rUK and Scotland with respect to EU regulations; but not always, and sometimes significantly - perhaps even fundamentally - in some cases. Two current examples help illustrate the point: (i) bankers' bonuses; (ii) the proposed EU turnover tax (the Financial Transactions Levy).

(i) In the first two of these the UK currently finds itself in a small minority in the EU, stemming largely from London's position as one of the leading international financial centres. The greater hostility felt by other EU members for bankers' behaviour and the excesses of financial markets partly reflects the relatively low importance they give to maintaining London's position as a global financial centre. While the proportion of financial services in Scotland's GDP may not be greatly different from that of the UK as a whole, it is distributed differently, with much less emphasis on providing a range of global markets and a much greater concentration of commercial banks, notably at

retail level.[11] The limits on bankers' bonuses would probably be less detrimental to Scotland's financial institutions and markets, perhaps much less so, than to those operating in the rUK. An independent Scottish Government might quite legitimately see its priorities in the menu of EU Directives lying elsewhere. Furthermore, there can be no presumption that the population of Scotland would share the views of their counterparts in the rUK on this matter. Bankers probably enjoy even less popular support there following the failures of the two principal Scottish banks and the costs of their public rescues; measures that aim to clip the wings of bankers could align Scottish voters more closely with their EU counterparts than with the rUK.

(ii) The introduction of a turnover tax could also be considerably less detrimental to Scotland's financial sector than to the rUK's. The detail of such a tax is as yet undetermined, but it is likely to fall on capital market transactions – equity and debt trading – relatively more heavily than on transactions such as commercial banking, insurance and asset management, where products provided by Scottish institutions provided directly to customers play a proportionately much larger part of total activities. Insurance companies and asset management firms are significant participants in the capital markets and the tax would have to be reflected in their pricing behaviour; whereas the effect on the markets themselves in London would be much more direct and far-reaching. London's pre-eminence as a financial centre derives in part from the almost complete range of liquid financial markets that it provides. The threat that a turnover tax constitutes to London is the loss in volume and liquidity to a number of financial markets functioning there. Without knowing what such a tax would look like, it is to some extent a matter of conjecture just how damaging it might be to London; but regardless of the detail, it seems unlikely that Scottish interests would be threatened to anything like the same extent.

The general issue remains: while Scottish financial institutions remain an integral part of the UK financial system, it is unclear how much scope exists for the body of regulations that set the framework for the activity of its financial institutions to differ from those applying in rUK. At some indefinable point, those differences could amount to a fracturing of the UK financial system.

[11] HM Government, Scotland Analysis: Financial Services and Banking, Chapters 1 and 2.

6. Costs of Financial Regulation and Supervision

It is extremely difficult to determine at this point whether financial institutions will pay higher or lower fees than hitherto for the supervisory work of the PRA and FCA. The basis for funding these new agencies differs from that used by the FSA. Previously fees were set net of any fines collected by the FCA from firms in breach of its regulations. These fines have increased substantially in recent years following the financial crisis as the FCA adopted a more aggressive policy towards companies judged to have breached the regulations. Henceforth these fines will be retained by the PRA and FCA only to the extent they cover legal expenses incurred in prosecuting breaches. All other fines will be passed to HMT. One previous means of limiting supervisory costs to individual firms will no longer be available.

The PRA recently published its proposals for fees for the transitional year 2013-2014, with a deferred minimum fee and the supervised institutions separated into 10 different fee blocks, some of which differentiate between members of a block according to size. The size and other conditions attaching to some fee blocks make it virtually impossible to judge whether firms supervised by the PRA will find the bill for fees higher or lower than previously, given the further complication of recovering the transition costs of moving to the new system over a period of five years.

About all that can be said at this point is that the budget for the FCA for the transitional year of 2013-2014, combined within the Annual Trading Requirement for the PRA for the same year will amount to some £650 million, compared with the FSA budget for 2012-2013 of £578 million. Some firms will pay more than previously but how the additional charges might fall, firm by firm, can be no more than speculation at this stage.

There is the subsequent question of the basis on which Scottish firms post-independence would be assessed and charged for supervisory services by the PRA and FCA, a question that has had no public discussion so far. Should the PRA judge that Scottish incorporated firms have become riskier then the costs of supervising Scottish financial companies could rise accordingly following Scottish independence.

7. Financial Crisis Management – Crisis Management and Lender of Last Resort

As stated in the Memorandum of Understanding (MOU) attached to the Financial Services Act 2012, “the key principle of financial crisis management is to make clear who is in charge of what and when”. The Bank of England under the new Act has primary operational responsibility for financial crisis management, while the Chancellor of the Exchequer and Treasury have responsibility for any decision involving public funds. Where the Bank has notified the Treasury of a material risk to public funds, and either there is a serious threat to financial stability, or when funds have already been committed by the Treasury in these circumstances and it would be in the public interest to do so, the Chancellor may use powers to direct the Bank.

It is important to understand the background to the MOU and the kinds of situations they are intended to address. At the general level, financial crises and their repercussions are rarely fully anticipated. They frequently occur unexpectedly – warnings may be given but are ignored against the background of a period of economic and financial expansion - and spread in unanticipated ways to unforeseen parts of the financial system. They almost never repeat exactly. Data can either be fragmented or even unavailable, particularly if financial institutions and markets have been developing quickly, moving into new products or new markets. Excitement displaces painstaking analysis. Risk managers take their place in the corporate pecking order well below traders and marketers, usually in a climate of overheated competition amongst companies in the same sector. The reforms introduced following the current crisis should reduce the risk of repetition of such conditions at both the global and national levels. They should also reduce the costs of failures that do occur. But the financial world today is so interconnected and communications so highly developed – and continually evolving – that authorities now stress that they aim to mitigate the effects of any future crisis, and not promise to avoid them completely.

Annexes 1 and 2 set out two cases, each of which might have been systemic, which illustrate the difficult challenges and questions that arise for macro-economic supervisors, and for crisis management. Both illustrate the necessity for day-to-day knowledge of the markets and institutions involved.

There are a number of lessons from these two episodes in the context of Scottish independence. First, the supervisors and the central bankers were faced with judgements affecting a unitary financial system whose boundaries were clearly defined by the supervisory framework. Secondly, the judgements and decisions had to be made – and could be made - quickly and decisively. The problem arose in the small and medium-sized bank sector in the 1991-93 episode, not from systemically significant banks; but by acting early the Bank of England anticipated a crisis that could have reached the larger banks. There was no prior warning in the Barings case and it arose from unauthorised trading by an individual, not imprudent conduct by management. Thirdly, the Bank of England and HMT were called upon to justify their actions to the UK Parliament; the questions were testing but fair and objective. If a Scottish incorporated financial institution in a post-independence scenario were to encounter similar difficulties, the challenges to the supervisors and central bank could be very different; each case invariably is. Deciding when and how to respond is difficult enough, without the complication of two countries' banks and uncertain lines of decision making and accountability. There would be potential for delay, confusion and political dispute, with the associated effect on confidence and further turbulence.

The Financial Services Act 2012 and the associated Memorandum of Understanding set out clear lines of responsibility and a transparent sequence of steps for official action in the face of a financial crisis. A number of questions arise in considering whether the crisis management model set out in the Act and the MOU would cope with a situation in which financial institutions incorporated in an independent Scotland were supervised by the Bank of England, as proposed by the current Scottish Government.

Responsibility for prudential supervision does not automatically entail responsibility for crisis management. The functions are carried out by separate organisations in many countries, including the UK between 1997 and 2013. However the scope for misunderstanding and delay arising from poor communication (or even from bureaucratic rivalry) is increased where the two roles are separated. The former is alleged to have played a part in the collapse of Northern Rock.

The new arrangements formally place the responsibility for macro-prudential, micro-prudential supervision and crisis management in a single organisation - the Bank of England. All of the elements of a model that are directed at maintaining a stable financial system are placed under one roof. This is not to argue that these arrangements will be sufficient to prevent future financial crises, but they have a substantially better chance of anticipating them and mitigating the ensuing damage and disruption than one in which responsibilities are unclear and divided. But how would they operate in a situation in which the system they are designed to protect consists of financial institutions from two different sovereign countries?

The process of crisis management begins at the ongoing supervisory level, where the PRA uses its Proactive Intervention Framework (PIF) to determine "how and when the PRA will escalate its engagement as risks in relation to a firm increase".[12] At a certain point, judged case-by-case by the PRA, HMT will be notified of a risk to public funds. At that point the Bank of England has the responsibility for developing options for managing the risks to public funds. In some circumstances during a financial crisis, the Chancellor may use special powers to direct the Bank to take particular and specific steps to stabilise the situation, acting covertly if the Treasury considers that to be necessary.

Adapting this machinery to include Scottish institutions post-independence could prove problematic. The Scottish Government has not so far specified the means by which it would propose to participate in the decision-making process of the Bank of England with its enhanced powers and responsibilities. One route would be by explicit national representation on the Court of the Bank, or the Financial Policy Committee; or on the Board of the PRA where the decision is taken to activate the Bank's powers under its Proactive Intervention Framework (PIF). How its representative(s) would be entitled to vote, what would be done in the event of a difference of view split along rUK and Scottish lines, such as decisions on whether or not problems at a Scottish bank were or were not systemic, whether to withdraw the authorisation of a Scottish incorporated financial institution, whether the Scottish Government would be consulted or take the decision whether to commit public funds, are basic questions that have to be tackled and answered. Getting answers with the necessary speed and precision from two governments when a crisis is erupting is crucial; and apportioning any resulting costs could be far from easy.

The current highly integrated nature of the UK financial system brings other complications. At present the largest Scottish incorporated financial services groups have significant branches and subsidiaries operating in both countries, they may also act as agents for other

[12] Memorandum of Understanding on financial crisis management, page 1.

banks for clearing and settlements services on both sides of the Border. Should they face liquidity or solvency pressures the new crisis management arrangements would have to be structured to take account of its application to two different countries with separate tax and public spending powers. The internationally accepted convention whereby responsibility for supervising internationally active banks rests with the "home authority" – i.e. the country of incorporation of the holding company or lead bank – does not apply to questions of rescues or failures of banks. The current crisis has underlined the absence of such an arrangements.

The protracted and ill-tempered dispute between the UK and Icelandic Governments over the failure of Kaupthing Bank, and the arguments over the responsibility for compensating depositors and other creditors of the UK branches of that bank who suffered losses, is a recent example of this gap in cross-border crisis management. The MOU on financial crisis management addresses compensation to depositors and other creditors, where it is anticipated that the manager of the UK Financial Services Compensation Scheme will request financial assistance from the Treasury (including via the National Loans Fund) for the purposes of that scheme. The implications of this MOU are that any deficiencies in the event of the failure of a Scottish incorporated financial services group, would fall on the Scottish Government, placing potentially considerable strains on Scotland's financial resources, as it did on the Iceland Government. It would seem implausible that rUK taxpayers should pay for the financial consequences of the failure of a Scottish bank; but if it had been supervised by the Bank of England, a dispute could arise about whose responsibility it had been to prevent the failure. Any resulting delay in paying depositors could be de-stabilising.

The crisis management instruments available to the UK authorities under the new legislation comprise two elements: Emergency Liquidity Assistance (ELA) and the Special Resolution Regime (SRR). The ELA is the facility corresponding to what is commonly known as the Lender of Last Resort and takes the form of the provision of short-term loans by the Bank of England to firms that are at risk, but are judged to be solvent. That judgement is not always simple. When the value of financial assets is falling rapidly in distressed financial markets what is initially defined as a liquidity deficiency in a bank can quickly become a problem of solvency. Under the new arrangements any provision of ELA must be authorised in advance by HMT. This replaces an arrangement in which the Bank of England had discretion, within its own balance sheet, to provide Lender of Last Resort facilities. The changes represent another step in making clear who is in charge of what and when. If, however, the Bank of England continues to supervise financial institutions incorporated in an independent Scotland, the judgement on both questions – the decision whether ELA should be made available, and whether a Scottish bank was suffering problems of liquidity or solvency - would not fit easily into the new system. This is where the difficulties of dual capacity could be most acute: these decisions have to be taken quickly and decisively. Modern communications and media activities do not permit lengthy discussions or negotiated action. Delay can increase the risks of systemic problems; and early action can defuse a crisis.[13]

[13] See annexe 1

Whereas the ELA is designed to deal with banks that are solvent but temporarily illiquid, the Special Resolution Regime (SRR) aims to deal with failing and failed banks. The Bank of England is the resolution authority and triggers the SRR once the realistic prospect of recovery no longer exists. As the resolution authority, the Bank has a range of options for dealing with a failing bank which aim to preserve value for depositors and creditors of the failing institution, and keep the healthy parts of its business from being wound up by empowering the Bank to transfer some or all of the business to another company. It can do this by three methods: (i) transferring the bank's retail deposits and marketable assets and liabilities to another bank; (ii) transferring the business to a temporary bridge bank which would manage it until a buyer can be found; (iii) leaving the remaining assets on the balance sheet of the failing bank under a special form of insolvency (the bank administration procedure). The SRR also gives HMT power to take into temporary public ownership (TPO) the shares from existing shareholders by compulsory acquisition.

This menu of options represents a system for achieving an orderly means of protecting depositors[14] and reduces the likelihood of a wider financial crisis. The call on public funds is reduced and, spelling out the options and machinery brings clarity to creditors and financial markets when one or more banks face insolvency. One noted feature of the new arrangements is that HMT can, as a last resort, acquire the shares of the failing institution; and can decide when and on what terms the shares can be resold to the private sector.

One model post-independence could be to amend the system to permit the Bank of England to supervise Scottish incorporated banks and combine that with separate Scottish machinery for crisis management and the resolution of failing banks. On the face of it, that could reduce the scope for disputes between the two countries about how the responsibility and costs of dealing with a failing bank would be dealt with. For example, the Bank could act on an agency basis as supervisor with control of the use of public funds resting with the Scottish Government. Leaving aside the issue of accountability, in practice such a model would reintroduce complexity, and perhaps confusion, to a system that has as primary objectives transparency and simplicity. These are the guiding principles of this regulatory reform; such a model would seem to be reversing into complexity.

Even if the complications arising from the supervision of Scottish financial institutions being carried out by the Bank of England could be resolved, the relative sizes of the main Scottish banks to the newly independent Scottish economy could impose significant burdens on the Scottish taxpayer.

[14] Because of operating links with the Financial Sector Compensation Fund

8. The Cost of Banking Failure

The report by HM Treasury puts the total cost of rescuing the Royal Bank of Scotland in 2008 at £320 billion in recapitalising the bank and providing Government guarantees.[15] If an independent Scotland were to adopt the reforms being introduced by HM Government and apply them fully, the resulting cost could be a good deal lower than the 211% of Scottish GDP that this figure represented. Adjustments would have to be made for any reduction in the size of the bank since the crisis, the effect of any restructuring that was deemed to be necessary as a result of implementing the proposals of the Vickers report[16] to separate the commercial and investment banking divisions, and the effects of the introduction of a "living will" for the RBS banking group[17]. "Bailing-in" bond holders and some uninsured depositors, if adopted, could reduce the call on the Scottish taxpayer further. It also has to be assumed that an RBS supervised post-independence by the Bank of England would have had to strengthen its capital in much the same way as other UK banks are being required to do.

Nevertheless, even if these measures were to make a material difference to the cost of rescuing Scotland's largest banking group – and it should be remembered that both leading Scottish banking groups failed – it seems highly unlikely they would eliminate the cost to public funds. Putting a figure on that cost is extremely difficult; there is no certainty that some of the measures will be adopted or any reasonable means of measuring that effect. But the eventual charge on the Scottish taxpayer nevertheless could be very substantial – perhaps a significant fraction of post-independence GDP.

Much of the effort currently being made among Eurozone countries to form a banking union is directed at breaking the ruinous link between bank failures and sovereign indebtedness. A banking collapse in an independent Scotland would on this scale create that link at a very high level and impose a serious impediment to the country's ability to pursue macro-economic policies aimed at generating growth. Whatever the loss to the Scottish GDP that resulted from the fiscal measures introduced by the UK Government in the aftermath of the financial crisis, it is likely to be insignificant when compared to the losses in output and employment suffered by Ireland and Cyprus where the link between bank failure and sovereign debt was high – but not as high as would have been the case if Scotland was calculating its position as a separate sovereign state.

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[15] HM Government, Scotland Analysis: Financial Services and Banking, page 7

[16] Independent Commission on Banking, September 2011

[17] HM Government, Scotland Analysis: Financial Services and Banking, Box 1B

9. Other Considerations

The new system for the resolution of failing banks is legally linked to the early activation of the Financial Services Compensation Fund with the aim of reducing contagion to other banks and enhancing financial stability. Unless an independent Scottish Government were to decide to set up a separate resolution scheme with entitlements and operating features different from the new UK scheme, this link could be retained. However the question of capacity to meet claims would still exist: would contributions by Scottish banks be adequate to meet claims on its compensation fund if a major Scottish bank should fail? Or if the fund were pre-financed would the costs to Scottish financial institutions prove very onerous, given the disproportionate size of the Scottish banking sector relative to its GDP.[18]

Without reliable information on the breakdown of deposits by size and category in the Scottish incorporated banks, it is impossible to provide a realistic estimate of the call on a Scottish Financial Services Compensation Fund should the Scottish banks run into serious problems and be allowed to fail. Whether this would be allowed to happen would remain to be seen. There is official determination to abandon the "Too Big to Fail" policy in many countries; but much will depend on the circumstances at the time this policy is put to the test. There is insufficient information on the composition of the deposits of Scottish banks to allow even a rough estimate to be made.

For what it is worth, the total deposit liabilities of the current Scottish banking sector could be of the order of some 1000% of an independent Scotland's GDP, compared with Icelandic banks at over 800% and Cyprus' banks at some 700% of GDP.

10. The Fiscal Commission Working Group Report – Lender of Last Resort, Crisis Management, etc

As with its recommendations on how supervision should be conducted post-independence, the FCWG Report is mainly high-level and non-specific in addressing the issues arising in dealing with troubled and failing banks. It suggests that design options should include the machinery for intervening in cases of troubled, systemically important banks and burden-sharing arrangements. The need for swift decision-taking is recognised and for aligning supervision and crisis management on a super-national basis. It proposes that the framework should be designed to reflect the shared interests of maintaining a stable system in UK post-independence and should ensure that nation states – presumably rUK and Scotland – contribute to the potential costs in what it describes as "a fair manner".

There is no guidance on how fairness is to be defined or delivered; presumably this is an issue for post-independence negotiation between the two governments.

Crisis management, including Lender of Last Resort facilities, would be "coordinated on a pan-Sterling Zone" basis. The proposed arrangements for rescuing a failing bank raise

[18] HM Government, Scotland Analysis, Financial Services and Banking, page 25.

difficult questions and doubts. In circumstances where Government funds were judged to be necessary, the response of the fiscal authority would be co-ordinated through a "Macro-economic Governance Committee" the scope of whose powers and accountability are not spelled out. The report concludes that agreement would be required between the Scottish Government, the UK Government and the Bank of England to develop an authorisation and indemnification procedure for a system that has two separate fiscal authorities. This, it claims, should be straightforward.

The clear inference of these proposals is that because the current UK financial system would continue to function more or less unchanged, the costs of rescuing Scottish banks would fall partly on the rUK; and, presumably, any such costs arising from the rescue of a rUK bank would be shared by Scottish taxpayers. Even allowing for the shared interest in maintaining the continuing stability of the whole UK financial system, both the rationale and the detail of this proposal needs much further explanation. The UK financial system is not an asset jointly owned by the rUK and Scottish Governments such as, it is argued by the Scottish Government, North Sea Oil or the Bank of England. Some central elements of the system, such as the wholesale payments system, are privately owned and include foreign banks from the United States and Europe. It is difficult to think that a threatened failure of one of those banks would justify intervention funded by the UK taxpayer on the grounds that it could be regarded as an important participant in the UK financial system. In the current state of play, the UK Government would look to the home country. As the FCWG Report itself points out, there are fresh moves in the aftermath of the current crisis to rethink the treatment of cross-border bank failures; but they are some distance from a commonly agreed solution.

The FCWG Report recognises that these are difficult issues but provides no suggestions or insights on how they might be resolved. At the level of the individual rUK taxpayer or depositor, they would no doubt argue that if Scotland should choose to leave the Union and its banks go with it in terms of their chosen domicile, they cannot expect them to share the costs of their failure the magnitude of which, even allowing for the mitigating effect of the reforms introduced, could still be very large in relation to the resources of an independent Scottish Government.

11. Developments in the Eurozone

The Eurozone is currently providing a mirror-image of the challenges which arise for the UK post independence in the areas of supervision, regulation and crisis management – i.e. it faces a situation in which it seeks to unify or integrate the systems of 17 separate sovereign states. The discussions over the shape of a Eurozone Banking Union encompass all of these areas and appear to be some way yet from agreement among the member states, and in some cases between the individual countries and the European Commissions.

Progress so far has been uncertain and uneven. To some extent this is understandable as it has taken place against the changing background of a financial crisis not all of whose consequences were clear. The crisis management arrangements, for example, have been put together spontaneously and in a piecemeal fashion. The European Central Bank has provided

funding at short-term for banks facing liquidity pressures, expanding significantly the range of securities accepted as collateral. In October 2012, Mario Draghi, President of the ECB, announced that it "would do what was necessary" to relieve the pressures on Eurozone banks – an ELA in all but name. It is not clear whether this statement required prior authorisation by member governments, and is under challenge in the German Constitutional Court. Adding further complexity, the ECB is a member of the official group, informally named the Troika and consisting of the International Monetary Fund, the European Commission and the ECB, which negotiated the terms of the agreement directed at rescuing the economy and banking system of Cyprus. Among the terms was the closure or restructuring of two of Cyprus' largest commercial banks, a decision that would ordinarily fall to the Government of Cyprus.

The rationale for this decision is that the institutions which provided financial support to Cyprus should determine the terms of the rescue package. Whether this represents the model for future Eurozone systemic collapses remains to be seen; Cyprus may represent a special case.

Disagreements among members of the EU and the Eurozone are a familiar backdrop to eventual consensus, so it would be wrong to forecast a failure to provide clear answers to these problems; but the difficulties of forging agreement are formidable. And they may have been determined, one way or another, before an independent Scottish Government was in a position to influence them.

At the bottom of these difficulties is the question of "who pays" in the event of a banking failure and, a fortiori of a banking system collapse. The perceived incompetence of the quality of banking supervision in Cyprus was quoted as a factor in that case, and the disproportionate size of the banking sector there contributed significantly to the difficulty of finding a prompt and decisive solution. One result was a redrawing of the arrangements for burden-sharing, with some uninsured depositors and bond-holders being treated more harshly than had been the general case previously. Whether the redistribution was justifiable or not is not the point. It is that unifying the system for preventing and dealing with the failure of banks and banking systems is proving extremely difficult and full of surprises and unexpected challenges that increase with the number of participants and differences in their circumstances.

The broader relevance of these developments for the debate on Scottish independence lies in the fact that a banking union has been in existence in the UK, and working well, if imperfectly from time to time, for many years. That it failed to prevent the crisis here is not a phenomenon confined to the UK; apart from Canada and Australia few countries with developed financial systems avoided the current crisis. What is more important is that changes to the present UK banking union aimed at reducing the risk of systemic failure have been discussed and passed into law quickly and without the national tensions evident in the Eurozone coming into play. This was largely because the question of "who pays" were answered promptly: the UK tax payer.

12. Conclusions

The current Scottish Government has announced its preferences in respect of two of the main parameters of financial stability: the currency, where it would seek to form a joint Sterling Zone with rUK, and a regulatory regime in which the Bank of England would continue to supervise Scottish financial institutions and to operate the arrangements for crisis management. There is real uncertainty about how long these arrangements are intended to last. This uncertainty is compounded by a lack of clarity regarding Scotland's membership of the EU and the Eurozone; and about the implications for both the currency and the regulatory regime. One thing that seems fairly certain is that a lengthy and indeterminate transition period would take place during which the Bank of England would be asked to act in a dual capacity, supervising financial institutions from both Scotland and rUK.

Adopting such a system raises a large number of questions, many of which may be capable of being answered in negotiation with the UK Government immediately after the referendum. But others appear to be more fundamental, notably in matters of accountability and governance. A reassessment of the risk profiles of Scottish banks would take place, with a presumption that they would be required to meet high prudential standards. This could lead to cross-border tensions and leave Scottish financial institutions to reconsider their group structures and group headquarters.

Supervisors are public officials and servants of the state. Just as each country has its own Central Bank, each has its own supervisory authority, the two working closely together or in one institution, established by law and answerable to its legislature for the performance of its duties as defined in that law. Public officials cannot serve two masters in areas that are crucial to the safety and security of the state without giving rise to real risks. Attempts to side step that principle would lead to administrative complexity, confused governance and flawed decision taking.

A shared system of supervision and particularly of crisis management arrangements would, at the very least, sit awkwardly with the need for speed and decisiveness in dealing with problems in financial institutions. Most financial crises, whether affecting an individual institution or an entire system, arrive without warning and in a form that differs in its details from any precedent. There is no play-book for coping with them and normally little time in which to respond. It is crucial to provide the response quickly and authoritatively. The reforms introduced in the 2012 Finance Act focus on these requirements, simplifying the procedures and machinery of response and placing the responsibilities clearly for decisions and action in a crisis. Attempting to share those responsibilities as they apply to banks and other financial groups of an independent Scotland and those of the rUK could result in duplication of decision making machinery, uncertain chains of command – and downright muddle.

More than most areas of public policy, supervision and crisis management rely on attention to detail. Micro-prudential and macro-prudential supervision have to be consistent both in principle and in the exercise of their day-to-day operations, with macro-economic policies. Trying to stand astride two horses heading in diverging directions could lead, sooner or later,

to an expensive accident. The costs of dealing with that accident have to be allocated in a way that appears to those meeting the bill to be reasonable and fair. In a unitary financial system there has been no dispute about who pays. In a system in which the regulation, supervision and financial support of financial institutions is shared, the potential for dispute is virtually inbuilt; and on any reasonable calculations based on the relative size of its banking system, Scotland's tax payers could face real difficulty in meeting their share of the costs unaided if one or more major Scottish banking groups were again to face failure.

Annex 1:- The 1991-1993 Small UK Banks Crisis

During a period of rapid monetary expansion in 1990 and 1991, bank lending for residential housing grew quickly. House prices rose sharply. Borrowers over extended themselves but continued to borrow on the assumption that the increase in the value of their property would quickly exceed the amount of their indebtedness. Monetary conditions were tightened sharply, the housing price bubble burst and many medium and smaller banks experienced significant defaults among their borrowers. Some of those smaller banks had funded themselves from the inter-bank market and had loaned substantial amounts to other banks with direct exposure to the housing market, so they also found themselves facing difficulties. In a number of cases smaller banks had excessive concentration on both sides of their balance sheets, with over 80% of their loans directly or indirectly to the residential housing market and a similar percentage of their funding from wholesale inter-bank sources.

As inter-bank funding flows began to dry up, some small and medium-sized banks found difficulties in renewing their existing bank lines and reported this to their supervisors at the Bank of England. The early signs of a funding crisis affecting a large numbers of banks were evident and the Bank supervisors, recalling a similar episode in 1973-74, took quick action. They collected data on the liquidity positions of all banks, establishing where and when the pressures were likely to be most acute. The evidence suggested that if left unattended, a crisis affecting a large part of the UK financial system could quickly evolve. Confidence was beginning to collapse in the sterling wholesale deposits markets. The Bank then called in the principal clearing banks, all of which were satisfactorily liquid and which also cleared the transactions of almost all of those banks experiencing, or likely to experience funding pressures. The clearing banks agreed to support these banks with funding but requested a guarantee the amount of which exceeded the capacity of the balance sheet of the Bank of England. After consultation with the Bank, HMT undertook to provide the guarantee and the clearers continued to supply funds day-to-day to the small and medium banks. The Bank of England monitored the liquidity positions of those banks, effectively managing their balance sheets, day to day.

All of this was done covertly and the crisis was averted. Some smaller banks, notably those heavily concentrated in lending directly or indirectly to the residential housing market went out of business or were absorbed by larger institutions; but this was done gradually, without any depositor loss and with the damage falling only on shareholders. Parliament was informed and explanations given by Bank officials after the crisis had passed, and was content that the Bank had acted properly and consistent with its informal responsibility as crisis manager.

Annex 2:- The Barings Collapse, 1995

At around 5.30pm on a Friday in mid-February 1995, Peter Baring and Peter Norris, Chairman of Barings plc and Chief Executive Officer, Barings Securities Ltd, respectively, called on the Deputy Governor of the Bank of England to inform him that their securities trading subsidiary in Singapore had experienced a significant loss in derivatives trading on the Singapore and Osaka markets. They were unsure about the size of the loss, but it could be of the order of £300-400 million, enough to threaten the solvency of the entire Barings group. They were urgently investigating the position in Singapore and would keep the Bank informed. This came as a complete surprise to the Bank. A senior Bank supervisor had visited Singapore a month or so earlier and had been assured by the Head of Supervision at the Monetary Authority of Singapore that the UK banks with operations there had no problems to report.

A Bank supervisory team was quickly assembled and immediately set about assessing the damage that the failure of the Barings group might create. In particular they were asked for their view on whether its failure would threaten the financial markets and financial system in London. Their preliminary view, based on their knowledge of Barings activities in the markets and its group balance sheet, was that its failure was unlikely to cause a widespread crisis in London; the position in Singapore and Osaka was much less clear. Contact with the authorities in both those countries was necessary and senior supervisors were immediately sent to both countries to discuss the possible effects there. By midday the following day the losses were now estimated at over £600 million and investigations were continuing.

Meetings were arranged by the Bank with representatives of the leading UK commercial and investment banks to explore the possibilities of a rescue of Barings financed by the UK banking community. Over the weekend several other possible solutions were explored by Bank, none of which seemed likely to work. A decision was necessary before the opening of the Far East financial markets on Sunday evening. A meeting attended by representatives of all the leading UK banks was held in the Bank early on the Sunday evening for that purpose. It was not possible to quantify the scale of Barings losses and the banks involved decided they could not commit to meeting an open-ended loss. Barings, represented by a senior director, decided the group could not continue in business and announced that it would cease trading forthwith. The eventual loss was in excess of £830 million.

In the week following the closure of Barings the Bank of England acted as intermediary between Barings shareholders and a number of prospective buyers if the group. ING purchased the entire group with no loss to depositors and all costs falling on the Barings' shareholders.

The David Hume Institute

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