The 1990s will see major changes in the European financial services sector. Technological advances are transforming service delivery and organisational structures; the sector is becoming progressively more internationalised and competitive; and significant changes in its regulatory framework are being introduced. One element in this process is completion of the internal market of the EC. Several of the Directives in the '1992' programme relate to the financial services sector, while the commitment to free movement of capital within the European Community is bound to shake-up supply of and demand for funds. In addition, the increasing probability of monetary union in Europe can be expected to usher in a new institutional framework which will radically alter patterns of business.

For Scotland, the evolution of the European financial system over the next few years will pose a serious challenge. The financial and business services sectors currently employ over 9% of the Scottish workforce and have been easily the most dynamic parts of the economy in the 1980s, having created nearly 50,000 jobs in the last decade. Within the single market, financial services must be regarded as a sector in which Scotland ought to have considerable opportunities, in contrast to many segments of manufacturing for which distance from key markets and a lack of competitiveness do not augur well.

This article appraises the prospects for the Scottish financial sector in the single market, drawing extensively on a study carried out by the author (Begg, 1990). It starts with a profile of the sector in Scotland, then goes on to give an assessment of the anticipated effects on financial services of '1992'. Section III considers the opportunities and threats facing Scotland, and looks at possible constraints on successful adaptation. The fourth section considers the policy implications and is followed by concluding remarks.

I The Scottish financial sector

Scotland is unlike most parts of the UK other than London (West Yorkshire, with so many Building Societies HQs is another exception) in possessing the HQs of several substantial financial undertakings: two independent clearing banks; nine life assurance companies, six of which are independent; one major general insurer; one building society; and several internationally known fund managers. There is also a well-developed network of other corporate services, notably lawyers and accountants, although Scotland is under-represented in securities trading, merchant banking and corporate finance, and other more specialised services. Most of the employment in the sector is concentrated in Glasgow and Edinburgh, with the former having a broader range of general 'regional' functions, while Edinburgh has more of the specialist activity in the sector (for a review of the sector, see Draper et al., 1988).

This profile shows that the Scottish financial sector is strong in asset management, with recent figures suggesting that Scottish companies have 20% of the UK market for life assurance, manage 35% of UK investment trust funds, and have a total of over £280 billion of portfolio funds under management (Scottish Financial Enterprise - SFE, 1990a). Although the UK is the principal market, some of the asset managers have expanded into international markets. However, Scottish financial entities have only a limited presence in EC countries. Latterly, several foreign-owned financial entities have established in Scotland, and another recent phenomenon has been the inward movement of 'back-offices' of companies in the banking, insurance and credit-card sectors.

1. I am grateful to the Scottish Foundation for Economic Research for support.
FIGURE 1

Share of Employment in Scotland in Financial and Business Services

FIGURE 2

Employment in Scotland in Financial and Business Services, relative to UK
In the 1980s, growth in demand for financial services was phenomenal, and this is reflected in the growth of employment in the sector in Scotland. As figure 1 shows, there was a steady rise in the number of jobs in financial and business services, which now stands at about 179,000. Just under half these jobs are in the banking, insurance and related sectors which are how financial services might be more narrowly defined.

However, the performance of the Scottish financial sector has to be seen in perspective. During the 1980s, employment in financial services in Scotland grew less rapidly than in most other regions of the UK, with only Northern Ireland lagging behind. This is shown in figure 2 which presents 'location quotients' (LQs) for Scottish employment in financial and business services. The LQ shows the ratio of the share of financial services employment in a region to the same share for the country as a whole. A ratio higher than 100 signifies that a region is relatively specialised in the sector. It can be seen from the figure that Scotland is not only below the UK average for its share of employment, but has slipped relatively over the 1980s. These figures reflect the very rapid growth of the financial sector in the 'South' regions of the UK, and need to be interpreted with caution. It is argued, for example, that a count of employees does not tell the full story since it cannot show income growth. It is certainly true that the earnings of the Scottish financial sector have been impressive, although comparisons of value-added in the sector in Scotland relative to other regions broadly confirm the trend shown by the employment statistics. Detailed statistics suggest that it is non-financial business services in which Scotland has failed to keep pace with other UK regions. Given that the single European market and other changes expected to affect the financial sector in the 1990s will intensify competition, there must be some cause for concern that Scotland is not having as much success as it might.

II The effects of completion of the internal market on financial services

Within the '1992' programme, there are three main types of measures that will have an impact on the financial services sector:

* Those relating to the supply of banking, insurance and other financial services are aimed, essentially, at facilitating the entry of financial entities from other EC countries into markets from which they have either been excluded or have faced restrictions on their activities. In principle, this will intensify competition in the sector, and could see weaker players eliminated. Because distribution networks will remain the key to market share, the opening up of the market is not expected to cause much reduction in the number of branch offices. It may, however, mean a gradual increase in the proportion owned by foreign financial entities, resulting in regional shifts in the location of management and control functions.

* Freeing of capital controls is the second category. This will accelerate the restructuring of financial systems in countries which have a relatively illiberal financial regime and could draw funds to areas which offer the most attractive returns on financial instruments. For Scotland, already subject to a regime of free capital movements, this presents little obvious threat. Freedom of capital movements may facilitate the expansion of life assurance and fund management activity based in Scotland into the Southern EC countries, such as Spain, Italy and Portugal. These countries have been subject to restrictions on capital movements that have inhibited the development of private sector savings products, with public debt being the main form of wealth holding.

* The third class of changes concerns cross-border corporate links. By facilitating takeovers, mergers and alliances, the '1992' measures will encourage concentration of the financial services sector within the EC. This is likely to reinforce a probable trend towards rationalisation resulting from excess capacity. Most leading financial entities are based in major financial centres such as Paris, Frankfurt and London, and are the most likely predators. On balance, financial entities with head offices in Scotland, being relatively small, are more likely to be prey than predators, so that the Scottish economy will probably be vulnerable to this phenomenon. This could lead to a drift of top-level functions (senior management, specialist services and so on) away from Scotland as a result of an acceleration of...
corporate restructuring. As the financial sector in Scotland is one of the few still to retain a sizable number of head offices, this would be particularly noticeable. Any loss of these could have an adverse effect on the prospects for the business services sector as a whole, as it would erode the client base and could undermine the viability of such services.

Demand for financial services will, in addition, be affected by the general restructuring that will take place in the European economy because of '1992'. If there is a concentration of headquarters activity in a smaller number of centres, this will be likely to influence the location of financial activity. Similarly, if there are regional disparities in income growth, it would not be surprising to find 'retail' financial services doing best in regions that do well.

II.1 The 'Costs of non-Europe' in financial services

Research carried out for the European Commission by Price Waterhouse (1988) has identified considerable scope for greater efficiency in the provision of financial services in the EC. The potential microeconomic gains for the sector are put at between 11 and 33 billion ECUs. Since the aggregate gains postulated in the Cecchini report (1988) are put at between 170 and 250 billion ECUs, it is immediately apparent how significant the changes in the financial services sector are expected to be. These estimates are calculated from the unweighted 'prices' of a range of services in banking, insurance and securities compared with an average of the four lowest prices in each category. Interpretation of these figures needs care, as they represent a 'snapshot' at a point in time and do not reveal the possible prices on offer for a wide range of financial services. Despite this, the data do provide an indication of the relative efficiency of each country within their respective regulatory frameworks and of potential for improvement.

Overall, the Netherlands, the UK and Luxembourg, followed by Germany have the smallest potential price falls of the countries studied. The markets which have the largest potential falls are Spain followed by Italy and France. The Price Waterhouse remit did not cover the other four EC countries, though a separate study by Booz Allen & Hamilton (1989) suggests that Ireland's financial sector has a similar profile to those in other Northern European countries. In Portugal and Greece, by contrast, the sector is much less developed. On the basis of the price differentials in the report, retail services offer the highest potential for price reductions, that is, the most attractive area of expansion in new markets. Spanish banks and to a lesser extent Italian banks will face the highest degree of competition given the potential price falls in these countries.

II.2 The regional pattern of financial services activity in the EC post-1992

The terms of reference of the Price Waterhouse study did not include attempting to determine specifically regional consequences of completion of the internal market, so that it is only by inference that these can be deduced. Retail banking, by its nature, is fairly evenly spread in proportion to population, whereas activities like securities trading or specialised services to corporate customers are traditionally located in major business centres. However, in many countries, regional identities are strong and regional loyalty can be expected to exert an influence on the way the financial system evolves in the single market. These considerations suggest that the regional impact of '1992' may be rather muted.

This was partly borne out in a study conducted by PA Cambridge Economic Consultants (1990) for the European Commission which sought to appraise the likely regional impact of the single market for financial services. Responses to a survey carried out across the EC repeatedly emphasised the importance of distribution networks with local staff and identities as the key to successful market penetration. This suggests that it is unlikely that major foreign banks would seek to build up 'greenfield' branch networks. In services to corporate customers and in the wholesale and securities markets, the EC market has already become fairly internationalised, although the creation of the single market will further this process.

In addition, there is evidence in many countries of changes in the internal regional pattern of activity in financial services. Thus, in Germany and Spain it is anticipated that the rather fragmented character of the sector will be
rationalised, with the leading centres (respectively, Frankfurt and Madrid) gaining at the expense of secondary financial centres. By contrast in the UK and in France, the trend may be more towards functional specialisation in different regions. London and Paris will become still more concentrated in the most specialised services with dispersion of more routine activity to other centres. The research suggested that regional change would generally be most pronounced (whether favourably or unfavourably) in those regions which currently have secondary financial centres or in the financial capitals of smaller countries (Brussels for example) which could face intense competition from larger rivals like Paris or London, rather than in the less prosperous regions where financial activity is predominantly retail.

Financial centres focusing on niche markets for the whole of the EC rather than for national markets may also be encouraged. The prime example today is Luxembourg, which has developed a niche in financial trusts. Other cities, such as Dublin and Amsterdam are attempting to develop in a similar manner. Edinburgh, too, is well-placed to develop such a role, whereas Glasgow, at present is more orientated towards the 'secondary centre' role described above.

III The outlook for the Scottish financial sector in the single market

Scotland has undoubted advantages in the financial sector on which it ought to be able to capitalise in the single market. The cost base is low, certainly relative to the City of London. It has a mature and established financial community with a solid core of professionals and a good international reputation. Scottish asset managers are respected for their probity and for their investment management skills. There is also a good network of supporting business services which gives the Scottish financial sector a 'critical mass' lacking in some other regions. Other positive factors include a reasonable availability of clerical labour with the necessary educational qualifications, and an adequate supply of office premises.

Nevertheless, there are actual or potential weaknesses which could cause difficulties. One is that very few Scottish financial entities are big by European standards. This creates a vulnerability to takeover. Mutual status is often cited as a protection against takeover, but does not preclude agreed mergers. Indeed, it is important to note that agreed takeovers, which are intrinsically more probable than hostile ones, have the same potential effects in diminishing HQ activity. The recent indications from Murray Johnstone that they were seeking a partner is a case in point. Lack of size also means that it is relatively more difficult to enter new markets where there are significant scale barriers to entry. Alliances such as the Royal Bank-Banco de Santander arrangement provide a possible answer, but the impression gained from survey work (reported in Segg, 1990) was that Scottish financial undertakings have been slow to form European links and may be too conservative in their strategies. Given the importance of distribution channels in securing sales, this is worrying.

Although leading figures in the sector are highly regarded for their professional skills (as actuaries, bankers or fund managers) they are inclined to be more product than market orientated. Some respondents felt that this will be a weakness in the single market where there will be a greater need to market services and to package them for different cultures and market segments. Arguably, the relative lack of direct air services to other EC countries from Scotland exacerbates this sense of remoteness from markets.

Scotland is also more dependent on the performance of the UK financial sector than some would like to admit. Much of the growth in business in the 1990s came from England, particularly in the wake of the private pensions legislation. Most of the inward moves of back offices have been from the South East, and many of the opportunities that will arise in the single market will be in partnership rather than in competition with City of London entities. The overall impact of '1992' on the UK financial services sector can, therefore, be expected to be a major determinant of how Scotland fares. On balance this is expected to be favourable, and the outlook is undoubtedly better now that Britain is participating fully in the EMS and, with Mrs Thatcher's resignation, is adopting a more positive attitude towards 'things European'. However, the regulatory framework in the UK is widely seen as a handicap, and there is concern that other financial centres such as Luxembourg and Dublin are able to offer more favourable tax regimes. This is a cause for concern in fund
management where they compete directly with Scotland.

The most obvious opportunities for Scotland are in the asset management sectors (life assurance and fund management). This was reaffirmed in a study by Ernst and Young (1990) for the SDA which also judged the non-life insurance and retail banking sectors to have 'moderate' (that is, less than 'medium') opportunities, though the latter is thought to be subject to threats from increased competition and acquisitions. Holmes (1990), in a survey-based study of financial services in the Lothian region, similarly paints a reasonably optimistic picture of the prospects for these sectors. Other segments of the sector - merchant banking, securities firms and venture capitalists - are believed by Ernst and Young only to have low opportunities because their business is already highly internationalised. Ernst and Young were, however, mainly concerned with opportunities for existing businesses. Hodgson and Brown (1990) maintain that 'there is no reason why Scotland should not aspire to be one of the principal venture capital centres of Europe'. Nor should the scope for Scotland to benefit from indigenous development and inward investment stimulated by '92' be overlooked. Scotland must be regarded as an attractive location both for the more routine processing functions and for certain specialised activities.

IV. Policy implications

The Scottish financial sector has to be seen as a critical one for the Scottish economy in relation to '92'. It has already shown its ability to earn income from outside Scotland and clearly has the potential to build on this in the single market. Several policy issues arise in considering how the sector can best be assisted to achieve this objective. Relevant policy issues fall under three main headings:

- Encouraging suitable conditions to support the sector
- Control and regulation
- Sector development

IV.1 Suitable conditions

Many of the factors that require attention if the financial sector is to prosper are widely recognised. Essentially, success in financial services depends on the existence of a well trained pool of professional and clerical labour and on the ability to communicate effectively with customers. The financial sector has diverse, though readily identifiable training needs, and these should, consequently, figure prominently in the priorities of Local Enterprise Companies and other bodies concerned with training. Access to air services is important for the sector in maintaining close contact with its markets (it is no coincidence that leading financial centres are also major air transport 'hubs'), and it is to be hoped that policymakers will give sufficient weight to this in formulating transport policy. In the same vein, telecommunications equipment and services, which can be expected to develop rapidly in parallel with the completion of the internal market will need to be upgraded as new technologies become available.

These are hardly controversial demands, but they merit restatement in the context of the single market, because the fluidity that '92 will bring to the market for financial services is likely to make small differences in conditions more critical than in periods of greater stability. Strategic decisions (for example on relocations) taken in the next few years by financial entities will have a lasting effect on the spatial pattern of the sector's evolution. Other 'background' factors can also be expected to affect Scotland's prospects. Decisions on land use in relation to office building or the construction of support facilities like conference centres or hotel accommodation. Even parking and traffic management can be regarded as facets of a location's attributes which will influence choices in what is sure to be a very competitive field.

IV.2 Control and regulation

Although decisions on the regulatory framework governing the sector or on rules relating to controls such as capital adequacy ratios are being taken at national or EC Commission level, it is vital that specific repercussions on the Scottish financial sector should be acknowledged. SFE has played a key role in this respect in lobbying for the regulations to be drafted in ways that do not harm Scottish financial entities. It is, nonetheless, important that the Scottish Office, the Bank of England and the relevant Whitehall Ministries should appreciate that the interests of Scotland are not automatically identical to those
of the City. By the same token, there may be developments elsewhere that pose a greater threat to the Scottish financial sector than to other parts of the UK. It is to be hoped that UK negotiators will note that the distinctly un-level playing fields on which Luxembourg and now Dublin operate could have a greater adverse effect on Scotland than on the City of London.

A separate 'control' issue is the awkward one of mergers and acquisitions. For much of the 1980s, competition has been the main plank of M&A policy, with wider regional development considerations commonly being neglected. While the notion of a 'ring-fence' to protect leading financial entities is regarded as unhelpful because it would diminish the spur of competition, there is a case for imposing constraints on predators where there is a danger that loss of key functions would erode the coherence of the sector. This is particularly true of some of the leading financial entities in Scotland which, in large measure, have a mutually reinforcing impact on one another, which sustains the 'critical mass' of the Scottish financial sector. It has been argued (Begg, 1990) that despite their poor track record (notably in the Guinness affair), it is worth looking again at ways of imposing conditions and extracting guarantees from predators. One way for Scottish interests to be more forcefully represented in this context would be for the Secretary of State for Scotland to be given the responsibility for enforcement.

IV.3 Economic development

A much more contentious policy question is what role the public sector should have in the development of the financial sector. On the whole, financial practitioners are against public agency involvement, preferring to let the sector do what it does best. This has been reflected in the relative lack of effort on the part of public agencies to become involved in financial services. Yet it is undeniable that some recent employment creation in the sector, particularly inward moves of back offices, is largely the result of initiatives by the SDA or Locate in Scotland. It was argued in Begg (1990) that despite their poor track record (notably in the Guinness affair), it is worth looking again at ways of imposing conditions and extracting guarantees from predators. One way for Scottish interests to be more forcefully represented in this context would be for the Secretary of State for Scotland to be given the responsibility for enforcement.

Perhaps predictably, these proposals were not well received by the financial community. In a press release, for example, Scottish Financial Enterprise (1990b) asserted that 'delivery, not deliberation' should be the priority, and that the 'talking-shops of the 1970s have no place in the development of the Scottish financial sector of the 1990s'. This response appears, however, to have missed the point of the proposals. The key role of a co-ordinating body is to ensure, precisely, that delivery is effective by avoiding duplication in effort, especially in a context where there are multiple agencies involved, and by enabling resources on a sufficient scale to be brought together when necessary.

The suggested public sector involvement would not, as the SFE press release implied, seek to supplant or to direct the activities of existing players in the sector. On the contrary, a primary function of economic development is to provide support where possible for new initiatives. At the same time, there may be projects which would not be undertaken in the normal course of events by existing players, so that a secondary function of economic development is to nurture new forms of activity. Arguably, some of the back-office activity in Scotland would have been lost without public sector intervention. The apparent success of the Dublin development and the joint efforts by the local authority and the financial sector in Amsterdam are examples of public-private partnerships that can stimulate new activity. It is in areas like these that public sector intervention can build on what the existing financial sector has achieved to reinforce Scotland's position in the single market.

V Concluding remarks

Completion of the EC's internal market will provide a real challenge to the Scottish economy. Many sectors will be under threat as a result of intensified competition and the operating disadvantages of Scotland's peripheral location in Europe. The financial sector, by contrast, has
the potential to do well in the European market of the 1990s. It has to be recognised, however, that it faces growing competition in what is a very fluid market place. With much to play for in European financial markets, it will not be long before rival centres are able to improve their attractiveness, and there will be a premium on being able to secure a position in particular market niches quickly.

It has been argued here that the Scottish financial sector needs to react quickly to the challenge of '92' if it is to exploit its undoubted advantages. It is also argued that public policy has to treat the financial sector as of strategic importance in relation to the single market and to adapt its policies accordingly. Failure on either side will have damaging consequences for Scotland, and could have lasting repercussions.

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