Executive Summary

Recommendations for UK Government in advance of Article 50 negotiations

Significance of the Scottish Financial Services Sector. Given the significance of financial services north of the border, the UK Government should appoint a permanent delegate(s) to represent the Scottish sector when future international trade deals are being negotiated.

Transition. The negotiation of transitional arrangements, irrespective of the UK Government approach to leaving the EU (i.e. fully remaining within the European single market, or otherwise), is critical to ensure certainty over this period and to mitigate disruption for financial services post Brexit. Scotland would be particularly sensitive to the lack of transitional arrangements as there are proportionally more small financial services enterprises in Scotland compared to the rest of the UK. Smaller firms are less likely to have the organisational structures in place to deal with the loss of passporting and will be highly dependent on transitional arrangements while they adapt their business models. We strongly urge the UK Government to ensure effective transitional arrangements are negotiated.

Talent & Migration. Access to talent is a key concern for the Scottish market place – the ability to recruit non-UK EU nationals is not only an issue for Scottish financial services but also for other vital parts of the Scottish economy, such as tourism. Scottish financial services has a reliance on Scottish universities for recruitment and EU 27 national graduates are a significant part of the annual intake of recruits. If restrictions on EU nationals are to be implemented, then careful consideration should be given to whether (less restrictive) more enabling measures could be applied to support financial services in Scotland.

Passporting Freedoms. Retaining current passporting arrangements would clearly be the Scottish industry's preference. Several firms view the retention of passporting as fundamental to their operations; as access to passporting was a key driver for their original decision to locate in the Scotland. However, the various public statements made by decision makers on both sides of the debate and the wider political environment suggest this is unlikely. Therefore we strongly urge the UK Government should prioritise negotiating a proxy as close as possible to existing passporting rights for financial services firms

Legal impacts. UK negotiations must take into account the fact that Scotland has its own legal and judicial system, or there may be unintended consequences that adversely impact Scottish financial services. Scotland has its own well established and world renowned legal system.
Significance of the Scottish Financial Services Sector

- Scotland mirrors the UK overall with a strong and diverse financial services sector. Edinburgh is the 4th largest financial centre in Europe and second in the UK. Scotland has international banks; large universal banks operating across retail, SME and corporate markets; global asset managers; global asset servicing companies; wealth managers; general insurers; life companies; FinTech companies; and a highly developed professional services sector.

- In 2013 financial services in Scotland contributed £8.2bn\(^1\) to the Scottish Economy. Financial and Business Services in Scotland has delivered year on year growth of 8.7\%(2) in the year to 2016 with this growth sector directly employing some 217,600(2) staff. With the addition of support services, contractors, private equity firms, venture capital, data services and analytics companies; Scottish financial services makes a contribution of truly national scale and importance to the UK and European economies.

- Scottish financial services output has increased by nearly 20% over the last 5 years (19.9\% from Q2 2011 to Q2 2016)\(^2\). Output is now 8.1 per cent above the pre-recession peak in the third quarter of 2007. More recently Scottish financial services has become one of the largest contributors to Scottish GDP performance, a leading growth sector in the Scottish private services sector.

- It is vital that the potential implications of the UK leaving the EU for Scottish financial services are fully understood by the UK Government and policymakers as they approach negotiations. Given the role financial services plays in the Scottish economy, Scotland would be disproportionately affected if negotiations were not to be mindful of the implications for financial services.

Given the significance of financial services north of the border, we strongly recommend appointing a permanent delegate(s) to represent the Scottish sector when future trade deals are being negotiated.

Transition

Irrespective of the UK Government approach to leaving the EU, the industry needs a period of transition to mitigate against uncertainty and avoid high transition costs for company’s and their customers.

Companies would be able to plan more effectively, comply with the new regulations and make the necessary organisational changes (including: the creation of European entities, establishing ‘substance’ for those entities, relocating personnel, rewriting the array of legal agreements between distributors, managing entities, associated services providers and products). A transition period would also provide the UK Government and EU time to negotiate the optimal mutually beneficial alternative arrangements.

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\(^1\) Source: UKTI Publication “Scotland Financial Centre of Excellence” – Scottish Government Statistics

Why it matters: Financial services provide a vital service to the economy through supporting businesses and households with the efficient allocation of scarce resources. A transition needs to be established as soon as possible in order to allow companies to continue to operate as usual over the transition period whilst adapting to whatever the “new world” brings.

What is the evidence to date: Scotland’s economic performance would particularly benefit from a transition period as, on average, there are more small financial services enterprises in Scotland compared to the rest of the UK (chart opposite).

Smaller firms are less likely to have the organisational structures in place to deal with the loss of passporting and will be highly dependent on transitional arrangements while they adapt their business models

We strongly urge the UK Government to ensure effective transitional arrangements are negotiated, agreed and announced as soon as possible.

Source: UK Business - Activity, Size and Location, ONS

The chart shows by enterprise size the positive and negative percentage difference between the number of firms in Scotland and the number of firms in the rest of the UK.

Talent and Migration

The dependency on the EU for talent varies considerably across the industry in Scotland. Many of our larger firms do have significant numbers of foreign nationals working in specialist, highly skilled areas, such as data science, digital, computing science, mathematics, languages and predictive analytics.

Why it matters: Financial services is ultimately a people business; it is about trust, professionalism and building long-term relationships. Scotland has a
competitive advantage in being able to provide high-quality products and services at competitive cost. This is possible in part as a result of Scotland’s strength in attracting people from across Europe, and globally, to work in Scottish financial enterprises and Scottish financial centres.

- **What is the evidence to date:** Scottish labour market statistics published shortly before the EU Referendum (tables opposite) demonstrate Scotland’s requirement for incoming talent from the EU, which is at a significant level. Additionally, other than London, Scotland has the highest rate of hourly pay for EU nationals, indicating those workers are involved in higher value add activities.

- To successfully maintain and develop Scotland’s financial services industry, we need to attract the best possible talent - whatever the country of origin. This is particularly the case when we consider the significant number of EU Nationals who graduate from Scotland’s further education institutions and enter the sector. Reducing movement of labour would negatively impact this talent pool.

Scottish financial services has a reliance on Scottish universities for recruitment and EU 27 national graduates are a significant part of the annual intake of recruits. If restrictions on EU nationals are to be implemented, then careful consideration should be given to whether (less restrictive) more enabling measures could be applied to support financial services in Scotland.

Contribution from workers born in EU 27 to Scotland Banking & Finance (K,L,M,N):

<table>
<thead>
<tr>
<th>Born in the EU (Non-UK)</th>
<th>Banking and Finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employment</td>
<td>20,000</td>
</tr>
<tr>
<td>Employment Share</td>
<td>4.8%</td>
</tr>
</tbody>
</table>
Average hourly pay for workers of EU 27 origin by region:

<table>
<thead>
<tr>
<th>Country or region</th>
<th>Average gross hourly pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>London</td>
<td>£15.31</td>
</tr>
<tr>
<td>Scotland</td>
<td>£13.20</td>
</tr>
<tr>
<td>South East</td>
<td>£12.87</td>
</tr>
<tr>
<td>North East</td>
<td>£12.05</td>
</tr>
<tr>
<td>Wales</td>
<td>£11.90</td>
</tr>
<tr>
<td>West Midlands</td>
<td>£11.43</td>
</tr>
<tr>
<td>Yorkshire &amp; Humberside</td>
<td>£11.34</td>
</tr>
<tr>
<td>East of England</td>
<td>£10.93</td>
</tr>
<tr>
<td>East Midlands</td>
<td>£10.32</td>
</tr>
<tr>
<td>North West</td>
<td>£10.16</td>
</tr>
<tr>
<td>South West</td>
<td>£10.12</td>
</tr>
<tr>
<td>Northern Ireland</td>
<td>£5.58</td>
</tr>
<tr>
<td>UK</td>
<td>£12.52</td>
</tr>
</tbody>
</table>

Source: Quarterly LFS (Jan-Mar 2016), 4-Consulting

**Passporting Freedoms**

Financial institutions with entities situated in the UK and other EU jurisdictions rely on passporting rights and the right of establishment to operate across borders. The prospect of the UK leaving the EU single market, where financial services passporting rights are lost, is a likely scenario that financial institutions must plan for. The loss of this freedom is likely to result in some restructuring for firms which may mean potential job losses/ transfers, and reduced UK revenue. The extent of the impact will be largely dependent on the organisational structure of each financial institution.
• **What is the evidence to date:** All sectors of Scotland’s financial services industry are impacted by the loss of passporting rights to varying degrees. In addition to the individual sector impacts, passporting loss could jeopardise the cluster effect, particularly in Edinburgh where we have our greatest concentration of FS businesses. Brexit, with its economic, regulatory, and access-to-market impacts, could provide further unwanted headwinds to the success of Scotland’s financial services sector.

• **Why it matters:** Financial services operate within a globally competitive environment, with both significant economies of scale (size matters) and scope (specialisation matters). As context Scotland manages more than £800bn in assets, a significant As can be seen from the HMT commissioned research chart opposite, Edinburgh is acknowledged as a transnational diversified centre. However, Scotland’s status is constantly contested by other centres across Europe and around the world and a growing proportion of these new assets; are for global companies.

Retaining current passporting arrangements would clearly be the Scottish industry’s preference. Several firms view the retention of passporting as fundamental to their operations. However, the various public statements made by decision makers on both sides of the debate and wider political environment suggest its retention is unlikely. Therefore we strongly urge the UK Government should prioritise negotiating a proxy as close as possible to existing passporting rights for financial services firms.

Key financial centres:

Source: Citi, Oliver Wyman
Legal impacts

Scottish financial services are underpinned by a robust legal and regulatory framework. Scots law incorporates many UK-wide requirements but also has many features which are unique to Scotland such as a separate judicial system and different legal entities such as Scottish limited partnerships.

- **Why It Matters:** In order to be competitive and attractive to investors, Scottish financial services must offer legal certainty and protection. A legal framework has been created by UK and EU legislation which gives such certainty and protection in vital areas such as insolvency, clearing, netting, collateral, choice of governing law and jurisdiction and recognition of foreign judgements. However, all of these areas have distinct Scottish aspects and any attempt to amend relevant legislation and regulation could inadvertently lead to adverse consequences under Scots law which would affect Scottish financial services.

- **Evidence To Date:** The process of “grandfathering” EU legislation into UK (and Scots) law has not started but past experience shows that new or amended UK legislation can impact adversely on Scottish commercial law. For instance, recent UK legislation on the Persons of Significant Control regime has had the unintended effect of potentially making the use of Scottish share security less attractive and as a result may impact upon whether Scottish legal entities will be used for certain investment purposes. This was not the intention of the UK Parliament and the massive task of incorporating EU legislation into UK legislation may overlook the distinctive nature of Scots law and could, for instance, impact upon Scottish insolvency law.

It is vital that the UK Government engages fully with the relevant legal and financial authorities in Scotland on any proposed legal changes arising from Brexit. There is a real possibility that changes implemented without consultation could affect the competitiveness of Scottish financial services if current legal protections are undermined.