

# **ECONOMY, ENERGY AND TOURISM COMMITTEE**

Wednesday 20 January 2010

Session 3

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### ECONOMY, ENERGY AND TOURISM COMMITTEE

#### 3<sup>rd</sup> Meeting 2010, Session 3

##### CONVENER

\*Iain Smith (North East Fife) (LD)

##### DEPUTY CONVENER

\*Rob Gibson (Highlands and Islands) (SNP)

##### COMMITTEE MEMBERS

\*Ms Wendy Alexander (Paisley North) (Lab)

\*Gavin Brown (Lothians) (Con)

\*Christopher Harvie (Mid Scotland and Fife) (SNP)

\*Marilyn Livingstone (Kirkcaldy) (Lab)

\*Lewis Macdonald (Aberdeen Central) (Lab)

\*Stuart McMillan (West of Scotland) (SNP)

##### COMMITTEE SUBSTITUTES

Nigel Don (North East Scotland) (SNP)

Alex Johnstone (North East Scotland) (Con)

Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)

David Whitton (Strathkelvin and Bearsden) (Lab)

\*attended

##### THE FOLLOWING GAVE EVIDENCE:

Steve Smit (State Street)

##### CLERK TO THE COMMITTEE

Stephen Imrie

##### SENIOR ASSISTANT CLERK

Katy Orr

##### ASSISTANT CLERK

Gail Grant

##### LOCATION

Committee Room 6



## Scottish Parliament

### Economy, Energy and Tourism Committee

*Wednesday 20 January 2010*

[THE CONVENER *opened the meeting at 10:33*]

### Decision on Taking Business in Private

**The Convener (Iain Smith):** Welcome to the third meeting of the Economy, Energy and Tourism Committee in 2010.

Agenda item 1 is consideration of whether to take item 4, which is initial consideration of the draft report on our banking and financial services inquiry, as well as all future consideration of that draft report, in private. Are members content that we do that? It is normal practice.

**Members** *indicated agreement.*

## Financial Services Inquiry

10:34

**The Convener:** Item 2 is the continuation of our banking and financial services inquiry. I am pleased to welcome Steve Smit, who is head of State Street investor services for the United Kingdom, the middle east and Africa and head of State Street Global Markets for Europe, the middle east and Africa. State Street is a leading provider of financial services to institutional investors. I ask him to make some opening remarks to outline the nature of his business and we will then open up the questions.

**Steve Smit (State Street):** Wonderful. Good morning, ladies and gentlemen. I thank the committee for the opportunity to provide evidence today.

I will start by telling you about State Street's business—more specifically, our operations in Edinburgh—and by explaining why Scotland offers an attractive environment for our business. I am also here to represent the wider asset servicing industry, which has been a tremendous success story for Scotland in recent years.

State Street is a US bank, chartered by the Commonwealth of Massachusetts. We were established in 1792 in Boston, where we continue to have our headquarters. We are a global institution with 27,000 employees and operations in 27 countries worldwide, providing services in more than 100 markets. As such, we are one of the world's leading servicers of financial assets. We operate three primary lines of business: investment management through State Street Global Advisors, which manages a little more than £1 trillion in assets; investment research and trading through State Street Global Markets; and our investor services business, which is really the core of our franchise and in which we custody or administer approximately £11 trillion in financial assets for our customers.

We provide services solely to institutional investors. Our clients include major pension funds, investment managers, central banks, sovereign wealth funds, endowments and insurance companies. What they all have in common is that they hold large portfolios of assets. As an asset servicing business, our role is to handle the custody, administration, accounting and reporting of those assets. Primarily, they are equities and fixed-income instruments, although the types of instruments that our clients employ to implement their investment strategies are becoming increasingly complex. As custodian, we are responsible for the safekeeping of those assets on behalf of our clients.

We also handle the settlement of our clients' trades in those instruments and the related reporting and administrative functions, such as the processing of corporate actions and the collection of dividends and interest. We also provide a range of ancillary services to our clients, including cash management, foreign exchange, securities lending, derivatives processing, collateral management, compliance monitoring, risk management and performance measurement.

As members can see, we are not really a bank in the conventional sense. We are not a retail bank—you will not find State Street on the high street—and nor are we an investment bank. More than 80 per cent of our revenue is determined by the value of the assets that we custody, administer or manage. Therefore, lower asset values mean lower fees, and that is one of the primary ways in which the financial crisis has impacted on us.

We are proud of our operations in Edinburgh, where we employ 750 people out of a total UK employee population of just under 2,200. That makes us the largest asset servicing provider in Scotland by number of employees. We began operating in Scotland in 1998, when we purchased the Bank of Scotland's trustee business, which employed about 50 people in Edinburgh. Since then, we have grown our operations through acquisition and organic expansion.

In 2000, we won a major investment operations outsourcing mandate from Scottish Widows and, in 2003, we acquired Deutsche Bank's global securities services business, including the WM Company, which specialised in measuring investment performance. We have since consolidated our operations into our current Ferry Road location at Crewe Toll. Today, our operations in Edinburgh include custody, fund accounting, performance measurement, risk management, trustee services, operations support for our investor services and global markets businesses and information technology support for our UK business and clients. As well as our UK clients, we service clients in the middle east, Africa and parts of mainland Europe.

To give an idea of the importance of our Scottish operations, our UK performance and analytics business, which is based in Edinburgh, provides services to 80 per cent of UK pension funds by asset value. Its clients include 90 per cent of local authority pension schemes in the UK. Our UK trustee business, which is also based here, was recently ranked number 1 in a major industry survey.

Edinburgh is an especially good fit with our organisation's culture. Indeed, many parallels can be drawn between the city and our home base of Boston. For a start, Edinburgh is not the UK's primary financial centre and Boston is not the US's

main hub, but both are major centres for the asset management industry; both have thriving cultural, arts and history scenes; and both are blessed with world-renowned educational institutions. The characteristics that make Boston such a successful base for our business can also be found in Edinburgh.

As our Edinburgh operations have grown, we have established a huge amount of intellectual capital. That is testament to the expertise of our Scottish workforce, whose skills underpin the success of our operations here.

Scotland has always had a strong reputation for financial services, and our own experience of operating here certainly backs that up. A couple of key factors make Scotland attractive as a base for the financial services sector. First and foremost, Scotland has a committed and well-educated workforce, thanks in part to the high quality of Scottish educational institutions. Employee retention is easier because the employment market is smaller than it is in London. That is critical, because the success of our business depends on strong long-term relationships with our clients and we benefit from having long-serving employees with a detailed understanding of our clients' businesses. Our business values the strong work ethic that characterises the Scottish workforce, which is renowned for its skills and hard work. Indeed, our Edinburgh operations are prized around our organisation globally for their diligence and can-do attitude.

Cost is another important factor. As Edinburgh is second only to London as a major financial centre in the UK, it has many of London's advantages while being a more cost-effective place in which to operate.

I will conclude my remarks with a comment on Scotland's asset servicing sector, which has grown rapidly from a standing start in the mid-1990s to become a key driver of employment growth in Scotland's financial services industry. Many other global asset servicing companies have operations here including Bank of New York Mellon, Citibank, BNP Paribas, JP Morgan and Morgan Stanley and a total of 3,800 staff are employed in the sector in Scotland. In fact, the country now has one of the largest concentrations of asset servicing companies in Europe, which is good news for us and the other companies. It means, for example, that we can attract leading talent, because people know that they can build a career here.

Scotland is a fundamentally attractive place for financial services. No market has been unaffected by the financial crisis, but Scotland has the infrastructure, scale and talent to emerge from the downturn. I thank the committee for its time and welcome members' questions.

**The Convener:** Thank you for a very useful rundown of your operations in Scotland and the reasons why you chose to locate here. Can you give us a breakdown of what your 750 staff in Edinburgh do? For example, how many are involved in the administrative work of accounting, data handling, IT analysis and so on and how many are involved in the more professional side of the business?

10:45

**Steve Smit:** The vast majority of our staff are in what we would consider to be the high-value-added end of our services, such as fund accounting. For example, our legacy WM business in Edinburgh provides our performance and analytics, compliance monitoring and risk management services. In effect, it works with our clients to identify where the investment performance in their portfolios is being derived. On the risk side, we work with clients to stress test their portfolios and see how they would perform during financial turbulence. The calibre of our Edinburgh employees and the level of services that we provide out of our Edinburgh operations are towards the higher end of the spectrum.

**The Convener:** I wonder whether I can press you on that. I do not want any specific details, but can you indicate the average salaries or salary scales for the 750 staff in Edinburgh?

**Steve Smit:** I would say that salaries range from approximately £22,000 to £25,000 up to £105,000 or £110,000 for the managing director. As for average salaries, I can get back to you with an exact figure, but I estimate that the average across the organisation is in the £38,000 to £45,000 range.

**The Convener:** You said that you came to Scotland in 1998 when you took over the Bank of Scotland's trustee business. Were there any other factors that made you think that Edinburgh was the place to establish and grow your business?

**Steve Smit:** The acquisition of the Bank of Scotland's trustee business was probably the driving factor. During the 1990s, State Street moved towards being a much more global institution. Although we had established operations in London in the 1970s, they remained relatively small up to the turn of the century. Once we established our presence in Edinburgh, the attractive environment, the quality of the workforce and the relative cost benefit became quickly apparent to us and encouraged us to grow our footprint in Scotland.

**The Convener:** Scottish Development International has established an operation in Boston. Does State Street have any links with it

and, if so, have they been a factor in your decisions?

**Steve Smit:** I do not think that there was a link when we made the acquisition in 1998. I assume that there is pretty close contact now, although I would have to confirm that with my Boston colleagues. Certainly, my local colleague John Campbell has remained very active in industry bodies such as the Financial Services Advisory Board and Scottish Financial Enterprise and we remain in close contact with bodies that are trying to promote Scotland as an attractive place to do business.

**Lewis Macdonald (Aberdeen Central) (Lab):** I want to explore that a little further. You said that you decided to invest in Edinburgh because an acquisition opportunity had come up and you had a desire for growth; you then said that the sector as a whole was beginning to grow. Obviously, you cannot go into any detail about the business decisions of competing bodies, but what do you think has attracted other US and international players in the asset management sector to the city?

**Steve Smit:** I have already highlighted factors such as the skills and education levels of the workforce. In our business, once an institution establishes a presence somewhere, the others tend to follow because there is a readily available pool of experienced labour. Also, as Edinburgh is a major centre for the asset management industry, asset services companies such as mine are able to locate themselves in close proximity to a major segment of their client base.

**Lewis Macdonald:** From what you have described, State Street's business is very high value. Are there other parts of your business that you might regard as having potential for location in Scotland? In other words, is all of what you do in the sector that you described, or does your institution have other types of business that you might look to grow in Europe and specifically in Scotland?

**Steve Smit:** We would always consider Scotland as a location. As part of our strategic imperative, we, like most other businesses, are subject to significant cost pressures as our clients endeavour to lower their expense base and to have us reduce our fees to them. Consequently, we continually look to re-engineer not only our processes but the locations where certain activities occur. To that end, given Scotland's relative cost advantage, certainly within the UK, the prospects for our growth here are good.

**Lewis Macdonald:** That is interesting. The committee is interested in how effectively the Scottish Government engages with the financial services sector and how effectively incentives and

encouragement bring inward investment of the type that you described. The convener asked you about SDI's engagement. Have you dealt with Scottish Enterprise while you have been here? Have you looked at any of the options that it promotes in relation to growth? Has it been part of what has clearly been a successful expansion in the past 15 years?

**Steve Smit:** We maintain an active dialogue with Scottish Financial Enterprise. My colleague John Campbell, whom I mentioned, acted as chairman of Scottish Financial Enterprise for six years, until recently. He is therefore familiar with the organisation and has a strong interest both in its success and in promoting Scotland as a recipient of investment from the financial services industry. I would say that we have a regular, open and frank dialogue.

**Lewis Macdonald:** I am sure that my colleagues will pursue with you issues to do with the financial crisis that we have all encountered and which prompted our investigation. From what you describe, I pick up no sense from your perspective that Scotland's reputation as a location has been in any way tarnished as a result of what has happened to some of the other institutions that are headquartered here.

**Steve Smit:** The crisis was global in nature. It impacted on financial institutions around the globe. Although certain institutions that are based here suffered detrimental impacts from the crisis, I would not say that Scotland's reputation has been tarnished any more than those of other major financial centres around the world.

**Lewis Macdonald:** Therefore, if your board in Boston asked for your view on expansion in Europe, you would give a positive response on Scotland as a location.

**Steve Smit:** Yes, absolutely.

**Lewis Macdonald:** Thank you.

**Rob Gibson (Highlands and Islands) (SNP):** Good morning, Mr Smit. We are thinking about the impact of the financial crisis on the financial sector in Scotland, and you told us that lower asset values are leading to lower fees. The range of financial services that State Street provides has been affected by the crisis. Will you tell us how the crisis has impacted on your business in a little more detail than just the headline?

**Steve Smit:** Yes. The obvious financial impact that is associated with the drop in asset values that you cite caused us to take certain actions. In the fourth quarter of 2008 and into the first quarter of 2009, the focus of investors turned away from earnings to the quality and depth of the capital bases of the various financial institutions. We undertook a plan to strengthen our capital base at

that time, which involved making some tough decisions. We cut our dividend and went through a workforce reduction programme of approximately 7 per cent of our employees globally. I am glad to say, with regard to our operations here in Edinburgh, that the impact was less than 1 per cent. At that time, we received money from the federal Government in the US in the form of the troubled asset relief programme. We subsequently raised more capital than we had received from the US Government. We repaid the US Government and now our capital ratios are among the strongest in the industry.

**Rob Gibson:** You said that very few employees were lost in Edinburgh. In respect of the business's influence from the Edinburgh base, you referred to the Edinburgh managing director. How is Edinburgh represented in your UKMEA management structure?

**Steve Smit:** The Edinburgh managing director reports to our chief operating officer, who is based in London, who then reports to me. He has responsibility for the oversight of all our activities here in Scotland, so the various functions and teams that I described all have reporting lines to him. State Street operates a very matrixed organisation, in which the product responsibilities are overlaid with a regional reporting structure.

**Rob Gibson:** That is very helpful. With a view to the crisis that we have been through, before we look to the future, would you say that you are at risk from counterparty failure in any way? If one of your clients goes down, does that mean that you go down or are badly affected?

**Steve Smit:** No. We put in place all the necessary legal protection to ensure that that does not happen. For example, our asset servicing contracts contain language providing us with a lean on assets and a right of offset, so that if one of our clients became insolvent, we could seize its assets and liquidate them to meet the client's obligations. That is a crucial element in ensuring that any problems caused by an individual institution do not become systemic in nature. It was recognition of the importance of the role that State Street plays in the financial system rather than our size that encouraged the US Government to support us in the aftermath of the demise of Lehman Brothers.

**Rob Gibson:** That is very helpful. Obviously, some of the assets that we have been looking at, such as the derivatives that have been built to try to buy and sell money, are extremely flimsy. I was thinking about those kinds of assets. I do not know how you would liquidate property such as that.

**Steve Smit:** The other aspect to keep in mind is that we act as an agent. In the course of providing the services that we do—specifically the



accounting and valuation services—we regularly value assets, even some of the very complex ones. In the asset management industry, in respect of the unit trusts, open-ended investment companies and other similar products for which we act as asset servicer, we calculate the net asset value that appears in the paper every evening or every morning. For other client segments, we create those asset values on a daily, weekly or monthly basis. Therefore, our ability to track the value of assets is probably second to none in the industry. In itself, that provides us with a level of comfort even with respect to some of the more complex and difficult-to-value assets.

11:00

**Rob Gibson:** In that sense, you are an agent, rather than a principal performer.

**Steve Smit:** Yes.

**Rob Gibson:** Did your stress testing of performance throw up any doubts in the period leading up to 2007?

**Steve Smit:** There was certainly nothing that was brought to the attention of the risk committees in State Street.

**Rob Gibson:** You have said that your capacity to recruit educated and qualified employees in Scotland is strong. Is there anything that you could recommend to the Scottish education system with regard to your needs? You said that the system is good, but how could it be better?

**Steve Smit:** I would urge the continued encouragement of investment in the education sector. We look for a workforce or employee base that is numerate in its skill set. Ultimately, we look to hire individuals with mathematical, financial and scientific skills. The strong presence of many professional services firms in Scotland is beneficial. There are accountancy type firms that produce the sort of numerate individuals whom we look for.

**Marilyn Livingstone (Kirkcaldy) (Lab):** In your presentation, you talked about your organisation being people oriented and focused. You said that one major draw of Scotland is its highly skilled workforce. You spoke to my colleague Rob Gibson about the skills that you regard as important, but will you say a bit more about how easy it is to recruit appropriately qualified staff in Scotland?

**Steve Smit:** I would characterise it as being relatively easy right now. In our experience, employee turnover is at historically low levels. Obviously, the environment has a tremendous amount to do with that, as there is uncertainty around the prospects for employment. Some individuals might be staying in their position because of that uncertainty, although they might

be willing to move to accept a greater career challenge or a position in which they see greater opportunity for career development.

**Marilyn Livingstone:** Do you have any liaison or discussions with our universities and colleges?

**Steve Smit:** We work closely with the University of Edinburgh and Heriot-Watt University, and we have a relationship with the University of St Andrews, too.

**Marilyn Livingstone:** Obviously, after our inquiry we will make recommendations to Government. It seems from what you are saying that you want the Government to continue to provide support to universities for education vis-à-vis the financial services sector.

**Steve Smit:** Yes.

**Marilyn Livingstone:** Is there anything else that we should recommend on the skills agenda?

**Steve Smit:** I would recommend continuing to encourage institutions in the financial services sector to remain extremely engaged with the education institutions. We are not unique in recognising that we need to provide all the support to the community that we can because only in healthy and thriving communities can we be truly successful. Therefore, engaging companies such as ours to continue to visit the universities to talk to students and actively recruit is a small piece of the puzzle.

**Marilyn Livingstone:** In your answer to Lewis Macdonald, you said that one of the draws for other companies coming from the United States is that there is an existing pool of staff because of the companies that are already here. We have talked a bit about universities and colleges. Does your company operate in conjunction with other companies on staff development, or is it very insular?

**Steve Smit:** We tend to operate in a fairly isolated way. Obviously, if there are pressing human resource issues that we believe affect the industry as a whole or segments within it, we will reach out to competitive organisations to understand whether they are seeing similar issues or having similar problems. In those cases, we will obviously work collectively to try to address them.

**Marilyn Livingstone:** I will move on to the crisis that has affected the sector. Has your company looked at restructuring or will it be restructuring? If so, how will that affect Scotland and your Edinburgh headquarters?

**Steve Smit:** We have undertaken a certain amount of restructuring through the reductions in our global workforce that I indicated have occurred. As part of our process redesign we are looking at our location strategy on a global basis,

and we have implemented a programme whereby what we consider to be low-value-added activities or services are located in what we term low-cost locations such as India and China. Within a region, we have regional low-cost locations, which in Europe might be markets such as Poland or eastern Europe. We also have locations where we choose to locate our higher-value-added and more complex services and locations where we feel that we require to be close to our existing client base. In that sense, and referring back to my earlier remarks about our locating higher-value-added services within our Edinburgh operation, I do not see that there will be any change there.

**Marilyn Livingstone:** Do you see any opportunity for growth in your Edinburgh operation?

**Steve Smit:** I definitely see opportunities for growth. We believe that the financial services sector in general will experience lower levels of growth in the coming years than it has experienced in the past 10 or 15 years; that is probably a fact of life. However, we also anticipate that there will be further consolidation within and across all segments of the financial services industry, including asset servicing, asset management, banking and finance. I certainly anticipate that we intend to be part of that consolidation activity, which will present us with the opportunities to grow our operations in Edinburgh substantially.

**Marilyn Livingstone:** Thank you very much.

**Stuart McMillan (West of Scotland) (SNP):** The financial services sector is now operating in a changing regulatory environment. What has been the impact so far on your company, and what will it be in future?

**Steve Smit:** We recognise that the regulatory environment is changing and appreciate that it needs to change. It is probably too early to say what the impact to date has been.

Several pending pieces of legislation, including directives, that are being discussed in the UK and in Brussels certainly have the ability to have an impact on our business. An example is the proposed alternative investment fund managers directive, which is being discussed in Brussels. In general, we support efforts to create a common authorisation and supervision framework, but several elements of that directive would be unworkable and would create challenges for our industry.

UCITS IV—the undertakings for collective investments in transferable securities directive—will also have an impact on the asset management industry. Most of that impact will be beneficial, but elements concern us. We are also aware of and

need to keep an eye on the widespread debate about compensation and remuneration.

Tax legislation in the UK is concerning. What is required is a clear, stable and consistent tax framework that is readily administrable. Knee-jerk changes cause concern for many institutions—not only those in financial services—because they create inconsistencies.

To answer your question, we are still waiting for the evolution in the regulatory framework to play out. We are actively involved in that dialogue in the UK, in Brussels and—obviously—in the US and elsewhere. It is probably too early to tell what the ultimate impact will be. Many levers are being pulled in London—in Whitehall—by the Treasury, the Financial Services Authority and the Bank of England. Given the upcoming election and possible comments in manifestos about changes to the regulatory system and to the institutions that regulate financial services, the environment is very uncertain.

**Stuart McMillan:** I fully appreciate that there is uncertainty in the environment. You said that it is too early to say what the implications will be. I assume that your organisation has individuals or teams of individuals who consider how potential outcomes would affect your operations in Edinburgh.

**Steve Smit:** Yes.

**Stuart McMillan:** Are you at liberty to say what the impact on your organisation here could be if some of the new directives and other legislation were passed?

**Steve Smit:** We are still undertaking that analysis. Many of the proposals from Brussels are Europe-wide, so Edinburgh and Scotland will be no more adversely impacted by them than other jurisdictions in Europe are. We will always do business in Europe.

As I said, the analysis is being undertaken, but I guess that there will be little or no impact on our operations in Edinburgh. Obviously, things that occur in London that relate to the UK as a whole have a bearing, but a significant element of our client base in the asset management industry and the life and pensions industry resides in Edinburgh, and I cannot see us changing our footprint in Edinburgh unless something dramatic happens to our client base.

11:15

**Stuart McMillan:** On your comments about knee-jerk reactions and tax legislation in the UK, what aspects of what has been proposed does State Street not agree with?

**Steve Smit:** The legislation to impose a temporary tax on bonuses reflects understandable public anger, but it is a one-size-fits-all remedy for institutions, such as State Street, that have very little culpability for the root causes of the financial crisis. It will impact on our employees in the same way as it will on employees of other institutions that played a more active role in bringing about the crisis. In many ways, the financial services industry has all been tarred with the same brush, although there are many segments and different businesses in it. There has been a one-size-fits-all reaction, and I caution that we should guard against that.

**Stuart McMillan:** You have mentioned a couple of things that colleagues will, I am sure, want to pick up on.

Finally, on the approach that has been taken until now to improve or change regulations, how important is a cross-border approach to regulation for companies such as State Street? Would vigorous regulation in one region result in State Street restructuring its global operations?

**Steve Smit:** Consistency and harmonisation of regulation are incredibly important. Companies that operate globally and have choices about where they locate their operations would prefer to be treated consistently wherever they operate. In the interests of maintaining a level playing field, regulation needs to be consistent; otherwise there will be a risk of regulatory arbitrage, with companies choosing to locate operations where they see the most conducive regulatory and legislative environment. A danger exists, and I would encourage the appropriate bodies in jurisdictions to come up with a consistent framework and approach.

**Ms Wendy Alexander (Paisley North) (Lab):** I will follow up on the issue of risk. You mentioned that prior to 2007 there were no issues that the risk committee saw fit to draw to the attention of the board. Have there been any changes to your risk management structures and policies as a result of the crisis over the past couple of years?

**Steve Smit:** Like most financial institutions, we have taken meaningful steps to strengthen the risk management function in our organisation. There are multiple facets to that. We manage our own risk—that of State Street—and, in doing so, we take a hard and close look at our clients and what they are doing. Credit risk is very important to us.

We operate businesses in the global markets area. We act as principals for foreign exchange, and the credit risk of our counterparties is critical. When we lend our clients securities we take in collateral to cover that credit risk, and we need to monitor and measure that in as close to real time as possible. We have taken steps to strengthen all

aspects of risk management within our organisation.

As for the services that we provide externally, you can imagine that risk management is front and centre in many or even most of our clients' minds right now. We are strengthening the organisation behind the services that we provide to assist them in analysing the risk in their portfolios. We view that as a significant growth area for us.

**Ms Alexander:** You mentioned that your capital ratios are among the strongest in the industry. Can you say a little about the regulatory structure to which you are subject? Which is the regulatory body or jurisdiction that has oversight of capital ratios?

**Steve Smit:** We are regulated in the US by the Federal Reserve, but we are also subject to the requirements of supranational bodies such as the Bank for International Settlements—the BIS—and to Basel II when it comes to establishing the minimum required thresholds. We are invariably regulated by the local regulators in the various jurisdictions in which we operate. Here in the UK it is the Financial Services Authority.

**Ms Alexander:** The Scottish Government has mooted the possibility of a separate FSA for Scotland. Would your organisation welcome that or have concerns about it in the context of regulatory arbitrage?

**Steve Smit:** Without knowing more it is difficult for me to answer, but we appreciate consistency and, depending on differences between the regulatory frameworks in the two jurisdictions, it would certainly have an impact on our choice of location for certain activities.

**Ms Alexander:** That is, if an additional regulatory jurisdiction was imposed on parts of your UK operations.

**Steve Smit:** Yes.

**Ms Alexander:** I wish to check something that you said earlier. Could you explain what you meant about being an agent or a principal?

**Steve Smit:** The easiest way to think about it is in terms of the risk that is associated with the activity. When we act as principal, the risk is transferred to us by the counterparty. When we act as agent, we are invariably standing between two parties to a transaction—we merely intermediate the transaction, so we assume none of its risk.

**Ms Alexander:** Roughly what proportion of your overall activities fall into those respective categories?

**Steve Smit:** In the vast majority of cases, we act in an agent capacity.

**Ms Alexander:** My final question relates to the changing regulatory environment. We have already touched on the role of Europe. Have you made any representations to the Scottish Government on any of the regulatory issues, or have you hitherto made representations principally to the UK Treasury?

**Steve Smit:** I do not believe that we have made representations directly to the Scottish Government, although I am sure that we have done so indirectly through our involvement with Scottish Financial Enterprise and the Financial Services Advisory Board. We would appreciate the opportunity to comment directly.

**Gavin Brown (Lothians) (Con):** Are there any downsides, for you, to doing business in Scotland?

**Steve Smit:** I cannot think of any. I was going to say the climate but, given that I was based in Canada before coming to the UK, I cannot use even that. We have discussed the quality of the workforce and the vibrancy of Edinburgh as a city. It has also been good to witness the infrastructural improvements that have been made. Transportation connectivity with the City of London and other financial centres around Europe is good. I cannot think of any downsides.

**Gavin Brown:** That is the right answer, as far as I am concerned. You mentioned the fact that in recent years—since 1998 for the organisation that you represent, and from a standing start in the mid-1990s or thereabouts for the industry as a whole—the asset-servicing industry has been a tremendous success story for Scotland. Other than the points on which we have already touched, are there specific things that you would like to see happen that would allow the industry to continue to be a success story for the next 20, 30, 40 or 50 years, so that it retains a firm base in Scotland and does not move?

**Steve Smit:** It is important to maintain the diversity of financial services in Scotland. The continued success of the asset management industry is important to us, and there is no reason to doubt that that industry will continue to be successful. As I said, we believe that there will be further consolidation in financial services. That is not a particularly Scottish issue—we believe that it will happen globally—but invariably consolidation is good for one party and not so good for the other. It is important to ensure that Scottish financial institutions continue to benefit from consolidation. On the whole, we feel confident.

**Gavin Brown:** You have pretty much answered my next question, but I want to be absolutely sure. When discussing European legislation, you made a specific reference to the alternative investment fund management directive, which we debated in the Parliament last week. The matter is relatively

time critical now—movement will happen under the Spanish presidency. Is there anything specific that you want to say about that draft directive as it relates to State Street or your part of the industry?

11:30

**Steve Smit:** We have considerable concerns about the proposal to impose strict depository liability, which I think is a reaction to the demise of Lehman Brothers and the difficulty that certain institutions or investment funds had in retrieving their assets in the aftermath of that.

We in the custody industry have traditionally operated under a reasonable standard of care, which has served us extremely well. We believe that the imposition of strict depository liability would not be beneficial for the industry as a whole. Without doubt, it would lead to the exit of certain players and to increased costs that would not be borne solely by the asset-servicing industry but would be passed on to clients. Ultimately, that would mean higher fees and greater expense for the investment management industry, which it is likely would be passed on to the end consumer of those products, be they a pensioner or a retail investor. That is one part of that piece of legislation that concerns us.

Another concern is the framework for the delegation of responsibility for undertaking certain functions. It would be a requirement that such delegation could take place only to a European Union entity. Although State Street provides services in 100 different markets, we do not maintain EU-registered entities in those 100 markets, so our ability to delegate responsibility to a sub-custodian in a far-flung market would be seriously jeopardised. Those two areas—depository liability and the delegation of responsibility—are of concern to us.

**Gavin Brown:** Thank you.

**Christopher Harvie (Mid Scotland and Fife) (SNP):** Mr Smit, you spoke eloquently about the advantages of being based in Edinburgh. Would you define those synergies as going beyond the availability of a pool of very talented staff? Do they embrace what the city was always said to be strong in—the coffee-house gossip that propelled the financial centre?

**Steve Smit:** The diversity of the representation of the financial services industry in Edinburgh is highly beneficial, because it encourages the active exchange of ideas and thoughts through dialogue, which from an asset-servicing perspective—we service the life and pension companies and the asset managers—provides us with the ability to innovate. In many ways, innovation in financial services has become a bit of a dirty term, but at the same time it is very much a necessity. Being

close to a wide array of our clients enables us to develop an appreciation of their future requirements and to discuss with them in a collaborative way what the future needs of the industry will be, which helps us to have a say in shaping the industry's future.

**Christopher Harvie:** One observation is that, in some of your definitions, you seemed to describe something that, in an informal way, came close to being a credit rating agency. You spoke of examining the risks and advantages of particular styles of investment and yet, only about three or four miles from you in the same city, two of the biggest financial disasters of 2008 took place. People including Jeremy Peat, who came before the committee, said that we came within 48 hours of total meltdown, or of substantive meltdown.

Is a risk of the synergy that you accept people because they seem to be in control, only to discover that they have got themselves involved in things that are beyond their control? What is your perspective on that as—let us say—an old-fashioned banker? You seemed to inherit the trustee functions both of Bank of Scotland and of Deutsche Bank, which involve you acting like a finger-wagging Mr Mainwaring and saying, "You don't do that sort of thing." Did that factor play a role in the adventurous finance that the banks got up to subsequently?

**Steve Smit:** That is a very good question. I am sure that the committee has heard many versions of the causes of the financial crisis. As a holder of multiple assets, we witnessed institutional investors pursuing an insatiable quest for return in their investment portfolios. The excess of liquidity in the system promoted an easing up of credit conditions and, it is fair to say, standards, and it promoted an extensive use of leverage in the financial system. The pursuit of return in light of historically low interest rates facilitated or prompted much of the financial innovation that occurred in the development of new instruments and securities. With the benefit of hindsight, it is clear that they were not understood and, from a risk perspective, they were mispriced.

In terms of post mortems, there has been a lot of analysis, and I am sure that there will be more in future. I hope that the interactions that occur in an industry or singular location such as Edinburgh will go a long way to preventing a recurrence of that type of event.

**Christopher Harvie:** Much of the financial expansion of Edinburgh in the 1970s and 1980s owed a substantial amount to the attraction of Scotland as a centre of the oil industry, which attracted and brought in specialised investment and analysis. I am thinking of Wood Mackenzie and the international oil industry. What role could

an organisation such as yours play in what we could call the current carbon economics futures?

Scotland is relatively well situated for developments such as carbon capture and renewable power, and it is using both to drive further oil exploitation. Doing so is highly capital intensive. What role is there for organisations such as yours in revitalising that industry-based asset development, which seems to be fairly crucial to the survival and expansion of the energy industries in Scotland?

**Steve Smit:** Without knowing more about the situation, my initial reaction would be that, unfortunately, an institution such as State Street probably has a limited role to play. As I alluded to earlier, we do not operate many conventional banking services. We do not do much credit extension, for example. We tend to extend credit to our clients and their investment portfolios so that, for example, a unit trust client can meet redemptions from its investors without having to liquidate securities from the portfolio. In that sense, the role that we could play, if there is one, is probably limited.

Within our markets business, we are a tremendous proponent of providing facilities that allow greater transparency into markets to allow greater price discovery so that buyers and sellers have a price on which to base their products and services. If there are elements of that in your thoughts, there is a conversation that we could definitely have.

**Christopher Harvie:** I assume that, being in favour of transparency, you would have a critical attitude to investment programmes that are based primarily in secrecy jurisdictions.

**Steve Smit:** Yes, absolutely. We believe that financial markets truly thrive and investors are best served when there is openness and transparency rather than opacity.

**Lewis Macdonald:** I was surprised to hear your concerns about legislation on bankers' bonuses, given the way in which you have described your business. The salary scales you described seemed more in touch with the real world than is the case in some other parts of the financial sector. Does your bonus and remuneration policy reflect the same realism as your basic salary scale, or would such legislation threaten your ability to award stratospheric bonuses in circumstances in which you feel that they have been earned?

**Steve Smit:** Compared with many other participants in the financial services industry, we have always had a fairly conservative compensation and remuneration policy. We have been great believers in deferred compensation, and for a number of years we have had in place a

compensation structure that defers elements of compensation over three and four years. That has not been implemented as a reaction to proposed legislation.

We very much subscribe to the view that we want to pay for performance. We recognise that, in paying for performance, we want to attain our talent retention objectives. The deferral acts in two ways: it ensures that our staff act appropriately with respect to any risk to which they may be subjecting the institution, and it is a tool for retaining staff for the longer term.

We have implemented changes to the compensation structure this year. Historically, we have operated like many others in the financial services sector, in which base salaries have been relatively low and the variable component of compensation has endeavoured to make up for that. We are moving to a more balanced structure, in which we are raising certain base salaries, very much with the expectation that the incentive or variable component of compensation will be reduced in future.

11:45

**Lewis Macdonald:** That is, regardless, in a sense, of whatever legislative provision has been made.

**Steve Smit** *indicated agreement.*

**The Convener:** I have one final question. I was interested to hear you say at the start of your presentation that you make your money based on the value of the assets that you handle. Is that the appropriate way for a business such as yours to operate, given that most of your work is volume based rather than value based? The amount of work that you have to do for 100 million shares is the same whether they are worth £1 or 50p.

**Steve Smit:** That is a very good question. There is a transaction element—a volume-based element—to our revenues. At the risk of oversimplifying, there is a charge for each client based on the value of the assets that we custody, administer or manage. Every time a transaction is executed, there is an associated charge, so there are two elements.

The ad valorem fee structure is appropriate, because it is effective at aligning our interests with those of the client. In terms of growing revenues, we can be truly successful only if our clients are successful. In that way, our system makes a lot of sense, although you are right to think that it could pose a problem if our revenues were based purely on asset values and there was no volume-based element.

**The Convener:** That concludes the questions. I thank Steve Smit for coming along today and

giving us an interesting perspective on another part of the financial services industry, which is perhaps not as well known as other parts but which is very important in Scotland. I thank him for giving us a positive picture of the potential future for the financial services sector in Scotland.

11:47

*Meeting suspended.*

11:53

*On resuming—*

## Beaulieu to Denny Power Line

**The Convener:** Item 3 is the Beaulieu to Denny power line. I thought that it would be useful for members to reflect on the evidence that we received last week from the Minister for Enterprise, Energy and Tourism, and for the committee to decide whether it wishes to consider any further action at this stage. I propose that we ask the minister to keep us fully up to date with any developments with planning issues and mitigation measures as they proceed. Do members have any comments?

**Lewis Macdonald:** I want to highlight a couple of things. Jim Mather's evidence at last week's meeting raised questions that we need to follow up. A fundamental part of his argument, which he used on a number of occasions, was that we cannot require the companies to underground the line.

Since last week's meeting, my attention has been drawn to the consent for Torness power station, which was issued on 24 May 1978 by the Scottish Economic Planning Department. Condition (6) of the consent states:

"The transmission lines leaving the station will be carried underground for approximately 2kms to suitable sites for sealing end compounds, in order to preserve the visual amenity of the coastal plain."

That is a clear example of how a consent condition can require undergrounding of a transmission line while allowing the development to proceed. Therefore, we should press the minister further on his assertion that he did not have the power to require that.

The minister also said last week:

"We have left an option that could result in our obtaining some undergrounding."—[*Official Report, Economy, Energy and Tourism Committee*, 13 January 2010; c 2962.]

Members will no doubt have seen yesterday's newspaper headline "Power firms reject burial of Beaulieu-Denny cables: Campaigners' hopes are dashed as energy minister Mather's claim that part of line could go underground proves worthless". At this stage, that news is apparently being reported as a leak from one of the power companies involved. Given the circumstances, I imagine that the power companies will soon submit to the minister their formal proposals for mitigation measures and that newspaper story might well turn out to be accurate.

Given the assertions that the minister made both to the committee last week and to the Parliament the previous week, I think that we should ask him

to keep us fully informed of whatever proposals come to him and what judgments he makes on those. In the light of that reporting back, we might want to hear from him again at some future stage.

**Rob Gibson:** I think that we should look at what the minister said in his statement about the conditions under which he granted the consent. The application was for an overhead line. I do not want to compare the Beaulieu to Denny transmission line with anything that happened in 1978 or at any other time. The new line will follow the course of a well-established overhead line in the same place.

The minister also went to great pains to point out that the environmental liaison group and the tourism, cultural heritage and community liaison group will be involved. Clearly, those groups will have a bearing on the particular mitigation measures that are included in the 73 sets of conditions, which comprise some 300 items. It will take some time to set up those groups, although they should be set up soon.

In addition, in working up their plans, the energy companies will be required to create a construction policy handbook. As any member who has been a member of a tramline or rail line bill committee, will know—I am not sure whether, other than myself, any committee member has been involved in the parliamentary scrutiny that is required for such bills before any development can take place—the decision that is taken on such matters involves a relationship between the companies and the minister who has a locus in the matter. In this case, the minister has a locus not because the Government is providing the money for the project but because the minister has oversight of such matters.

There is an issue of timescale that we need to take on board. I think that it will be more practical to get information if we give the companies a number of months to work up their proposals. That will enable the minister to have a reasonable idea of what is happening and not just to surmise about the process. We should recognise that our committee is here to hold the minister to account for the way in which he delivers. In the context of what the committee has said, we need to see that what we wanted is delivered and delivered early. That was the force of our unanimous report.

I am concerned that we should not simply pursue good guesses in newspapers or hark back to things that happened in Yorkshire or Torness. In this case, the minister has been quite clear about the way in which he responded. If we are interested in taking an overall view of matters and the national importance of the development, we should keep that as our perspective. We should discuss the issue in due course when further

information is available so that we can discuss the matter in terms of reality rather than surmise.

**Ms Alexander:** I will make two precise points that follow up on Lewis Macdonald's comments.

I am strongly committed to renewable energy going ahead, but I think that everyone is looking for clarity. We should formally seek clarity on two issues. First, is it legal or illegal to impose undergrounding as a condition? Evidence suggests that such a condition would be legal because there is precedent for it, but we were given clear indications to the contrary. In fairness, if I recall correctly—perhaps someone could check the *Official Report*—those indications came from the planning officials. Given the apparent contradiction between what was said and precedent, we should write to the minister to ask him to clarify the issue. Clarity on that would inform every other similar application in future and would help all parties. I have no idea what the answer will be, but we should ask that question in writing so that we receive a considered response.

12:00

The second issue is to do with certainty and whether it is appropriate to pursue the process via a series of private, bilateral meetings with the interests concerned. One of my grave concerns about how the process is playing out is the precedent that is being set. Meeting the companies, having a chat with them and then releasing things into the press does not bring the certainty in the process that we want. Therefore, my second point—it is the same as Lewis Macdonald's second point—is that we should write to the minister asking whether the companies ruled out undergrounding at the meeting. It is important to ask that question so that every single other public interest that goes into the mitigation process will know what the options are. We must ask it because, at the moment, all those groups think, based on the ministerial statement, that they will be able to discuss undergrounding. If the companies have ruled that out to the minister, every other public interest deserves to know that as it tries to scope what the parameters of mitigation are.

We should write about those matters. There is precedent, and we would like to know the position. No doubt 20 officials will pore over that matter, and that is the right way to provide certainty. We also need to ask whether, as a result of the meeting that the minister indicated to the committee there would be, the companies have ruled out mitigation and undergrounding. Knowing that would be helpful for the various interests that will be involved in the mitigation process one way or another. We should ask those two follow-up questions to try to bring clarity to the process.

**Gavin Brown:** The suggestion that we should be kept up to date and fully informed as and when is sound.

Lewis Macdonald's point about what the minister said about his powers to compel or otherwise is important. Of course, his example came from the late 1970s and there may now be a different regulation or piece of primary legislation that explains why it is no longer relevant, but we can be told that in an answer if it is the case. It is perfectly legitimate to ask that question. I would think that there will be a definitive legal answer, which it would be good to have for the sake of clarity.

**Stuart McMillan:** It is incumbent on us to hold the minister and the Government to account, so I would be content for the minister to come back to the committee at some point to explain a bit more when he has more information to give us.

In fairness, it is probably legitimate for the committee to write to the minister about the Torness point that Lewis Macdonald mentioned. However, on undergrounding, there are 73 mitigation aspects, and I do not think for one minute that the energy companies will have decided within the past week and a half to two weeks what all the 73 mitigation schemes will be. Therefore, we need to have a time break before we try to establish exactly what has been ruled in or what has not been ruled out. I do not see it as viable in any way, shape or form for decisions on those schemes to have been made within two weeks. We should therefore allow a bit of a gap before we bring the minister back in front of the committee.

**The Convener:** I do not think that anyone is talking about bringing the minister back to the committee in the near future, but it may be appropriate to request him to come back when there is more clarity. I suspect that that will be some months away.

**Lewis Macdonald:** There are many conditions, but most of the conditions that refer to the possibility of changes to the wires relate to existing wires and not to the main Beaulieu to Denny line. Those areas where mitigation measures have been asked for are limited and specific. I think that the minister referred to three that he had inserted. In my view, the companies will make decisions on those specific areas very quickly, so I think that by the February recess it would be appropriate to ask whether they have made a decision. In that timescale, I am sure that the minister will be aware whether mitigation measures relating to the main Beaulieu to Denny line are likely to involve undergrounding. There is a distinction to be drawn between the main line and associated existing lines. Because the issue relates to the minister's powers in granting the consent, we should press



for an early response in February or March on the undergrounding of that link.

**Rob Gibson:** Given that the *Official Report* of last week's meeting shows that, in answer to Lewis Macdonald, the minister said that, at that stage, he had not had detailed discussions with the developers, as he had been waiting until after the decision was made, the point that Stuart McMillan makes is valuable—it would be helpful to give the companies some time to come up with specific proposals. Perhaps we should keep in touch with the minister to find out when those discussions will be held, but I do not think that we should interfere in that process.

The minister made it clear in his statement that consent had been applied for under section 37 of the Electricity Act 1989 and that deemed planning permission had been applied for under section 57(2) of the Town and Country Planning (Scotland) Act 1997. Could we ask what relationship the planning laws that were in place when Torness was approved have with the regime that came in under the Electricity Act 1989? Any changes in that period might rule out a comparison with Torness.

**The Convener:** Are there any other comments?

**Christopher Harvie:** It would be useful to take a positive look at what the future of long power lines in general will be, given the nature of the big power projects that will go ahead in the North Sea and the Mediterranean, because if we get our sums and our engineering expertise right, Beaulieu to Denny can be a prototype for the profitable application of our engineering expertise elsewhere in Europe, thus avoiding our being more or less at the whim of the power—as opposed to the power engineering—companies.

**The Convener:** Is there general agreement that I should write to the minister to ask him to keep us fully up to speed with developments as they proceed and to clarify why he considers that he does not have the legal power to require undergrounding? I will also ask what changes the two acts to which Rob Gibson referred made to the situation that applied in previous cases such as Torness. Is that agreed?

**Members indicated agreement.**

**The Convener:** I suggest that we also ask the minister to keep us informed of any detailed discussions that he has with the developers and any decisions that are made on undergrounding prior to any public consultation. Wendy Alexander's point was that if undergrounding has been ruled out, the public should know that before consultation takes place. I am sure that the clerks will be more eloquent in wording the draft letter than I have just been. Is that agreed?

**Members indicated agreement.**

**The Convener:** Thank you very much. That concludes the public part of the meeting.

Next week, we will continue with the banking and financial services inquiry. We are due to hear from the trade unions and from representatives of the campaign to establish a post bank. We also hope to hear from a representative of the asset management industry, but we will discuss that when we go into private session, which we now do.

12:09

*Meeting continued in private until 13:19.*



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