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Official Report

ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 24 February 2010

Session 3

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ECONOMY, ENERGY AND TOURISM COMMITTEE
7th 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)

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Alex Johnstone (North East Scotland) (Con)
Jeremy Purvis (Tweeddale, Ettrick and Lauderdale) (LD)
David Whitton (Strathkelvin and Bearsden) (Lab)

*attended

THE FOLLOWING GAVE EVIDENCE:

Willie Watt (Martin Currie Investment Management Ltd)

CLERK TO THE COMMITTEE

Stephen Imrie

LOCATION

Committee Room 5

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 24 February 2010

[The Convener *opened the meeting at 09:32*]

Financial Services Inquiry

The Convener (Iain Smith): Welcome to the seventh meeting in 2010 of the Economy, Energy and Tourism Committee. We have apologies from Gavin Brown, who is feeling unwell, so we wish him a speedy recovery. I hope that he has not been made unwell by the prospect of our second item of business this morning. Our main item of business is the final oral evidence session in our banking and financial services inquiry. Following that, we will move into private session to start our consideration of our report on that issue.

I welcome Willie Watt, who is the chief executive of Martin Currie Investment Management Ltd, which is a specialist investment management business that is based in Edinburgh. We are pleased that you have come to give evidence today, as we are aware of the importance of investment management in the financial services sector in Scotland. I invite you to make some opening remarks.

Willie Watt (Martin Currie Investment Management Ltd): Thank you for inviting me to give evidence today.

The committee's remit involves financial services, which covers a wide range of businesses, so today's meeting gives us a great opportunity to talk about one of the subsectors of our industry in Scotland. There are probably seven or eight subsectors in the financial services sector in general, but there are only three in Scotland: investment management, insurance and life insurance, and banking. My company works in the investment management part of the industry. I have 25 years' experience in investment management, working with Martin Currie and, before that, with the 3i Group, on the private equity end of investment management.

Investment management in Scotland manages about £600 billion of assets. Broadly speaking, that makes it the 11th-largest financial services centre in the world. Within equity investment management, Scotland is probably in the top 10, because it has a greater preponderance of equity investment management than exists in other countries. For example, in Europe, investment management is dominated by bonds, rather than by equities.

Three thousand people are directly employed in the industry in Scotland, mostly in Edinburgh, and there are a further 4,000 jobs in the investment servicing part of the industry—in the back offices, in which jobs are more broadly spread among Edinburgh, Glasgow and Dundee.

The industry has a global reputation: some 75 per cent of Martin Currie's clients are outwith the United Kingdom and many other companies also have substantial client bases outwith the UK. When I travel to the USA, Australia or Hong Kong, I frequently come across my competitors from Edinburgh—the Edinburgh companies are well known around the world. Those companies bring a lot of revenue into Scotland and provide a tax-paying base. The jobs that they provide are high quality and well paid, and the individuals who work in the industry pay a lot of personal tax. Furthermore, because of the international element of the business, they bring in a lot of foreign exchange. Most of us have pensions, life policies and so on, and the industry in Scotland contributes components to those policies and pensions through local authority pension schemes, the insurance element of the industry and the unit-trust side of it.

There is another benefit. During the financial crisis, there has been a lot of talk about reputation, and the reputation that investment management in Scotland has around the world is good. That has continued throughout the crisis, and is one of the things that offers something of a counterbalance to the damage that has been done to Scotland's reputation by the financial crisis.

What issues do we face? It is all very well for us to talk about the differentiation between banking and investment management, but most people in their day-to-day lives lump all financial services together, which means that there is inevitably a trust issue that covers the whole of the financial services industry, given the scale of the financial crisis. Also, markets have fallen significantly—massively, one might say—from their highs. Although the investment management industry cannot control the fall in global markets, that is clearly a negative experience for our clients, so we must try to help our clients through the experience of their pension policies and unit trusts falling in value as a result of the crisis. Obviously, for many people who are retired, their investments are a significant part of their ability to fund their day-to-day lives, so that is an important issue.

There is on-going uncertainty about the shape of any recovery and what that means for investment returns. Inevitably, the policy response to the crisis has manifested itself in regulation. Our industry needs to navigate its way through the increased regulation that is aimed primarily at the banking industry, but which also has implications for the investment management industry. Because we are all international businesses, we have to pay attention to the regulation of the US Securities and Exchange Commission as much as that of the Financial Services Authority.

There are other relevant issues. In the UK, individuals probably undersave for retirement. That is a big issue for our industry and for government as a whole. Financial literacy is another long-term issue that has not helped the population as a whole to navigate its way through the complicated set of problems that we have had in the past two or three years. Finally, we must consider the role of institutional shareholders in challenging the companies in which they invest on issues that have manifested themselves during the crisis. I am happy to talk about any of those issues or—obviously—anything else about which committee members wish to ask.

The investment management industry in Scotland is in good shape. The companies are healthy: they are taking people on and looking to the future. In our part of the industry, there is no sense of retrenchment or that tin hats are being put on and bunker doors are being locked.

The Convener: Thank you very much for that helpful introduction.

Will you expand on why Scotland has such a large presence in the investment management sector? What are the particular strengths that make Scotland a good place for investment management?

Willie Watt: Initially, that presence came out of the huge amount of wealth that was created in Scotland during the industrial revolution. The investment trust, which was invented in Dundee by Robert Fleming, was one of the first collective investment vehicles to be invented anywhere in the world—it was the start of the industry in Scotland. In many successful developing countries, once wealth has been created, the next phase is to diversify it by investing overseas. Many investment trusts—the Canadian railway investment trust, for example—had great names. In part, the sector grew out of the wealth that was created and the innovative skills of people such as Robert Fleming who created investment vehicles which, in turn, created a skillset in Scotland earlier than in many other places. The development of the insurance industry in parallel with the investment management industry also helped to create a critical mass of skills. Obviously, with life companies and insurance companies, there are always investment funds that require to be invested alongside other elements. All those things created that critical mass of people and skills, and Edinburgh was able to hold on to that in the 20th century and as financial services boomed in the second half of the 20th century.

That is the heritage. On why Scotland has such a large presence in the investment management sector now, I think that the point about skills still stands. Of course, in a global world that is connected by the internet and in which barriers to competition are relatively low, people can work from anywhere. The choice of Edinburgh as a location is partly driven by the fact that the people who want to work in the industry are happy to live and be based in Scotland. That works extremely well.

09:45

We might feel that it is a little glib but, around the world, the idea of canniness, prudence and the ability to manage money in Scotland still holds sway. The person who most recently told me that was the head of the Saudi Arabian Monetary Agency's investment division, which is based in Riyadh, to whom I spoke at a conference. Internationally, people still hold on to that idea. That was a bit of a long-winded answer to say that much strength remains in Edinburgh's location.

My final point is about the time zone. The UK is in a good time zone for running investment management funds globally, because it allows us to deal with North America and Asia. For people in North American time zones, dealing with Asia is extremely difficult, whereas we have enough of a crossover. That means that our guys work quite long hours, but we can do the world from the UK.

The Convener: I will ask a bit more about your business. You mentioned in your introduction that 75 per cent of your clients are from overseas. Why is your focus on overseas clients? From where do those clients largely come?

Willie Watt: The investment products that we are involved in making tend to concern global equities and derivatives of global equities, such as Asian or European equities. That is also the case for Baillie Gifford, Aberdeen Asset Management, First State Investments, Walter Scott & Partners and Edinburgh Partners. Quite a number of independent companies focus on international equities. That goes right back to the investment trust days that I talked about.

Such products can be bought by everybody who buys investment products around the world. Most investors—whether they are pension funds or individuals—have more invested in their domestic stock market than in international markets, for fairly obvious historical reasons. However, most people are now more interested in investing internationally, because that provides more diversification and because some of the best companies in the world are not British, Swedish or American but are from other countries. That provides an opportunity. Our view and that of other companies in the industry is that we would rather sell our expertise to a broad range of people around the world than focus on one area, where we would need to have a much deeper market share. If we focused only on the UK, it is realistic to say that not all of us could prosper. However, the world is a big place, so there is room for Scottish expertise around the world.

Such activity also gives us diversification of revenue. In November, I was in Australia, which has been pretty much untouched by the financial crisis. It has a huge mood of optimism and is in a dynamic phase. In global growth terms, people there feel that they have linked themselves effectively to China. Australia is very active, whereas the UK and the US still have a deep conservatism, which has been driven by the impacts of the financial crisis. For us and the other Scottish companies, it makes much sense to try to do business in a place such as Australia, where the sentiment is positive, instead of in places where people do not want to change anything because they are still risk averse.

The Convener: I note from the information that we have that roughly 18 per cent of your business is in public sector pension funds. Are those funds largely UK based? How much of that is from Scotland's public sector?

Willie Watt: We have local authority clients from Scotland and the rest of the UK. We also manage money for state pension schemes in the US, Canada, Australia and other parts of Europe. Pension schemes of one kind or another that are linked to state organisations form quite a major part of the sector globally. Some countries, such as Sweden, have pretty much all of their state pension pot in fully invested funds. Other countries do not invest to cover their pension liabilities. The UK is somewhere in between. It is a big market for the sector globally, and it has been more active than the company pension scheme market because it has been better funded globally. That is now going to come under pressure, I think, because—as you will have heard and we have all read in the newspapers—the pressure of the financial crisis is now being faced by the state sector. The focus is on pensions, and that will impact on the state's ability to be innovative in its pension schemes around the world. I say that with the caveat that, in places such as Australia, there is a hell of a lot less pressure than there is in the US and the UK.

The Convener: From your experience, have Scottish public authorities given enough opportunities to Scotland-based investment management companies to manage their funds?

Willie Watt: Yes. Public authorities have a fiduciary duty to pick the best managers regardless of where they are based, but they give all the Scottish managers a fair crack of the whip. You will find that Scottish managers are well represented in state pension funds in all areas around Scotland. That works well.

Rob Gibson (Highlands and Islands) (SNP): Turning to the general financial crisis, you were quoted in *The Scotsman* last year as saying that

"We haven't had systemic failures in all the major pillars of the financial word we have experienced this time around"

and that

"We were always taught there would always be liquidity in the system – that was a given. Clearly it wasn't."

Is that your view of the main causes of the current financial crisis?

Willie Watt: It is one of the contributory factors. A few months ago, Evan Davis of the BBC did a documentary. He put it quite well when he talked about the financial services industry's belief that there would always be liquidity in the system being a comfort that there would, for any given level of risk, be cover. He used the analogy of a motorcyclist who thinks that he can ride faster because he is wearing a crash helmet. The sector's belief in there always being liquidity meant that it took incrementally greater levels of risk that went way too far. It is a bit like a little kid walking on to the ice. The ice does not break and he thinks, "This is all right, so I'll just walk a little bit further." Of course, he is not getting true feedback about the level of the risk that he is taking. The sector took too much risk.

Also, because of 1929, Governments will always step in and provide liquidity to save the system. That is a given, and it is exactly what happened. The problem was that it was naive to think that the Government's response could be immediate: Governments have to decide whether responding is the right thing to do. In the gap between the crisis starting to unfold and the Government's response, the crisis became much deeper. The basic tenets that people like me grew up with were taken to illogical conclusions.

Rob Gibson: Are we talking about liquidity that is based on real assets or—

Willie Watt: Derivatives?

Rob Gibson: Yes.

Willie Watt: Both. There was a massive growth in liquidity, which was not in itself a bad thing, because it allowed the financial system to grow. What was bad about it was that ultimately the people who owned the financial assets had no relationship with the risks that were being taken on the ground. That was manifest most clearly in relation to the US mortgage debt, which ended up being owned by local authorities in Norway, which had no ability to judge the risks that were being taken in selling poor-quality mortgages in California.

The derivatives side made everything much more complicated. One of the problems was around the ability to value assets. Throughout the crisis, the stock market worked extremely efficiently. Globally, you could get a price on pretty much any stock, except the very small stocks, and you could trade that price. If you did not like the Royal Bank of Scotland, you could sell your shares in it. You might not like the price that you got for them, but you could exchange them for cash. In the derivatives market, and in quite a lot of the debt market, that completely fell apart. Once you cannot make a price, not only do you not have liquidity but you have big issues with seeing what anything is worth. That was made worse by the market accounting rules. They had the good intention of ensuring that people did not over-value assets and were never really meant to be used in an environment in which no price could be determined.

Rob Gibson: We are beginning to pay the price. Has the impact of the financial crisis on the investment management sector in Scotland been significant? You said earlier that you are in good health, but you also said that people with pensions and so on are not now going to get the returns that they expected. What has been the effect on you of that lack of ability to value assets?

Willie Watt: Martin Currie has always been ultraconservative in terms of liquidity. We did not have a lot of illiquid assets that we could not value. There were some issues around that for other companies in the Scottish industry but, to be honest with you, the crisis did not affect any of the Scottish companies very badly or, even, badly—although it did affect some in some ways.

The biggest direct impact of the crisis on the sector has been the fall in revenues. In investment management, you get paid a fee on the assets that you manage, which at the top end is perhaps 1 per cent of the assets and at the bottom end is perhaps 0.2 per cent of the assets, depending on whether the assets are bonds or equities. The fall in markets meant a huge fall in revenue, which put pressure on the profit and loss accounts of the companies.

There have not been major redundancies in the sector in Scotland, but there have been a few. The biggest impact has been the crisis of confidence in the whole investment world. I talked earlier about underfunding of pensions. It does not exactly give the man in the street confidence that he should be funding his pension when he sees the stock markets fall by 50 or 70 per cent. However, the fact that they have fallen does not negate the need to save and invest. The main crisis has been a crisis of confidence.

Rob Gibson: I think that we have covered restructuring.

You mentioned the excellent health of the Australian economy and your diversification of sources for investment. Do you have any message for investors in this country about the services that you have to offer and the returns that they are likely to get?

10:00

Willie Watt: The key message for individuals is that they need to provide for the long term. In the good old days when everybody had a pension scheme that was provided by their company or some state organisation such as a local authority, providing for the long term was not an issue because it was baked in with an employee’s salary package. That is increasingly no longer the case, but the penny has not quite dropped for people in this country. The time to make such provision is when you are young, but young people do not think about it. If I said to my 22-year-old son that he should really start saving for his pension, he would look at me as if I was a complete lunatic.

There is an issue about how we get people to save. The other issue is how the industry creates products that might not be exciting but are dependable. Absolute return is talked about. That approach combines different types of bonds and equities to give a plodding return that compounds over a period rather than looks for something that is really exciting but volatile. The man in the street is not capable of dealing with market volatility. That is not to do with intelligence; it is just to do with knowledge.

The Government has a responsibility to try to find ways to ensure that state and private sector employers do all that they can to encourage saving because, ultimately, the state ends up picking up the tab if people do not save. There are some good lessons to be learned from what Australia did on compulsory employer contributions into savings plans. From talking to politicians in the UK, I know that they are keen to try to ensure that people save. There is a responsibility not only to encourage the individual to save but to ensure that corporate entities have some responsibility for ensuring that individuals save.

Ms Wendy Alexander (Paisley North) (Lab): I will begin with a couple of questions on corporate governance. Our equivalent committee in the UK Parliament—the Treasury Select Committee—has described institutional investors as “supine and ineffective”. Do you share that view?

Willie Watt: Absolutely. Why would the Treasury Select Committee say that? It might be because the sector in Scotland, the UK and globally was invested in the Royal Bank of Scotland and HBOS. Were we asleep while the excessive risk was being taken?

One of the problems with bubbles is that everybody begins to believe the same things. I spoke to somebody who used to follow the Bank of Scotland during the time that it was run by Bruce Pattullo. It was prudently run but perceived to be somewhat unexciting. There was increasing pressure from investors to increase returns from banking, which contributed to the increase in risk that we talked about at the start of the meeting, so another criticism that we could make of the sector is that it was too return oriented and, therefore, the risk return profile was skewed.

We were all in the same boat because nothing like this had happened before. The risk was extended slowly and incrementally, and management teams and investors believed that the risks that they were taking were reasonable. With hindsight, that was clearly wrong. The issue was not so much that the investors were supine as that they believed the same things as the management teams.

With regard to corporate governance, there is a difficult issue in relation to separating the responsibilities of the shareholder from the responsibilities of the board of directors. If the shareholder is too dominant in their interaction with the board of directors, the board becomes disempowered, but a shareholder has no tools with which to change the chief executive. The biggest investors in Scotland, such as Standard Life and Scottish Widows, might own 5 per cent of a company such as the Royal Bank of Scotland—I am not saying that they did, but they could conceivably do so—but they would not be able to determine who should run the company, although they could give feedback to the non-executive directors.

Because the stock market is liquid, the theory goes that if I do not like what the Royal Bank of Scotland is doing, I can sell the shares. If that means that the company's share price falls, a Darwinian effect occurs, which will drive management change. The distance between the shareholder and the board is an issue. The non-executive directors are, in a sense, the mediators between the shareholder and the board; they are supposed to go out and get feedback from the shareholders. Large investors such as Standard Life have corporate governance teams that interact with firms, and they are pretty forceful in examining what the firms are doing.

The same thing happened during the technology bubble a few years earlier. The analysts, the shareholders and the boards were too close, and they believed the same things, which meant that they did not pull the levers that they could have pulled.

Ms Alexander: What, in policy terms, should we do about the chasing of yield in your industry, which you said led to the amplification of risk?

Willie Watt: I am not sure that there is anything that you can—or should—do about it. It is difficult to regulate. The problem companies were banks. The Government is interested in systemic risk. If a retail chain has ridiculously risky growth plans, investors back that company and it blows up, that is not good, but it does not create any systemic risk to the economy. When banks require to be bailed out on the scale that they did, systemic risk is involved. We are all living with the consequences of that now and will continue to do so for a number of years. The issue concerns the levels of risk that are taken by firms that are capable of systemic failure. It is clear, with hindsight, that the banks' gearing levels were excessive in terms of their equity-to-debt ratio, and tighter control of that would be one way to deal with the issue.

What differentiated the banks that failed from those that did not? I think that it was often the level of gearing. Perhaps we need to take a more clear-cut review of the outliers—that is, the banks that are taking more risk.

There is an argument that banks should be split up and that investment banking should be split from clearing banking and corporate lending. I am not sure that that is the answer, because many of the services that investment banks provide are needed by companies in our sector and by companies that trade currencies. For example, the Wood Group in Aberdeen has massive currency exposure all over the world, so it needs an investment bank to help it manage that.

Whatever happens needs to be global. If it is not global, companies will arbitrage between different locations. Global action will be extremely difficult to achieve, but the action needs to be around that. In a sense, I think that the sector will heal itself. What tends to happen is that, when too much risk is taken, the next phase usually involves—to be honest—too little risk being taken. We are probably looking at a period when the systemic risk will be quite low for a considerable number of years because there will be a shared sense within the sector of a deep aversion to risk. However, the problem is that all the people who have experienced the crisis will probably have retired in 10 or 15 years' time, and we will then have a new group of people who have not experienced it. That is why now is the time to put in place the right kind of policy requirements, although they might not be needed for quite a number of years.

Ms Alexander: I have two further questions on different topics.

In June 2008, a company spokesman was quoted in *The Herald* as saying that Martin Currie might consider moving its tax domicile if that made commercial sense, possibly to a Bermuda-based holding company. Is that still a possibility? Would you consider such a move?

Willie Watt: I am surprised that you should quote that because I have been chief executive since 2002 and I have always said that we would not move our tax domicile. We have a Bermudan holding company not for tax reasons but because we have US investors who have invested in our company. For various reasons it made sense to have a holding company based in Bermuda. We have no plans to move our tax domicile.

I am happy to answer questions on the issue, as it has been discussed a lot in the press and a number of companies have made such a move. I think that the issue is part of what we talked about earlier, which is that companies are moveable. In a global world with very sophisticated corporate services, companies can base themselves in many different locations. That means that Governments are in a competitive fight for head offices and tax revenues. Some people think that it would be unpatriotic to move the head office for tax reasons, but some people in business will not take that view. For Governments of all shapes and sizes, there is an element of competition—unless they harmonise tax on a global basis, which they clearly will not do—so that is a real issue.

10:15

Ms Alexander: I will conclude with some questions on remuneration. It was reported—you can confirm whether it is true—that the returns to Companies House in 2003 showed that Martin Currie made a loss of £700,000, yet in the same year one of its directors received a bonus and salary package of almost £1 million. In retrospect, do you think that that was an error?

Willie Watt: You are much better informed than I am, because I cannot remember what you are referring to. I do not think that we made a loss in 2003. In fact, we did not; we made a profit in 2003. I am happy to send you our report and accounts to confirm that.

There are three issues here. The first is whether bonuses contribute to increased risk taking. In the investment management world we do not manage our own capital; we manage other people's capital, so we are not betting the balance sheet of Martin Currie. Standard Life is slightly different, but investment management funds do not bet their balance sheets, so there is no systemic risk. Also, the outcomes become noticeable quickly—there cannot be a situation in which someone is paid a bonus in one year and something fails two years down the line but they have already been paid for it, but that can happen in banking. I would argue that the bonus issue in investment management is different from the position in banking.

The second point is one that organisations are grappling with now. If I have somebody working for me, or Stephen Hester has someone working for him, who has done an excellent job and met their set of objectives, it is not unreasonable that they should be paid the bonus that they are due within that context. That is a different thing from the chief executive of the organisation taking responsibility for the overall position that the company is in. I am often not the most well paid person in my company, because other people have done sensible things against their objectives. It could be sensible enough not to pay a chief executive a bonus but to ensure that people in the organisation are properly rewarded.

Interestingly, Martin Currie did not pay any bonuses in 2009. We talked to all our staff and said, "We can either make people redundant because of the drop in revenues or we can chop the bonus schemes completely." All the staff voted for no bonuses to be paid at all. We paid only 50 per cent of bonuses in 2008 for the same reason.

Ms Alexander: What were Martin Currie's profits in 2007 and 2008? I know that we do not have final results for 2009.

Willie Watt: I do not have those numbers in my head. The peak year for profits was 2007. The profits reduced in 2008. The numbers for 2009 have not been published yet, but they will reduce further.

Ms Alexander: Let me share with you the figures that we have for your company. They show pre-tax profits of $25.6 million, or £17.3 million, in 2007. It says here that, based on that 2007 performance, you were paid £1.6 million, which is about 10 per cent of the profits in 2007. Are those figures accurate?

Willie Watt: I do not think that they are. For a start, we do not quote our profits in dollars. I do not know where you got those numbers from. We would probably have had a better discussion if I had the same information as you.

My reward is based on three-year deferred payments that are based on the profitability of the company. I would have been paid based on a scale of payments that was agreed with our board, over a three-year period, based on the success that the company had. Many people in our business earn quite a lot of money. It is our business. We own it. In a sense, I am not quite sure what you want to know.

Ms Alexander: What were you paid last year? It is reported here as £1.6 million.

Willie Watt: In 2009?

Ms Alexander: Yes.

Willie Watt: I voluntarily took a pay cut last year, but my basic salary was around £200,000. I received no bonuses last year.

Ms Alexander: So the reported package of £1.6 million is not true.

Willie Watt: In 2009? I do not know where you are getting the—

Ms Alexander: In recent years.

Let me ask a different question, which is what I am really pushing at. There is a widespread issue about what percentage of banking revenues should be paid in pay and bonuses to senior staff. Martin Currie has 250 staff. What percentage of your profits last year went on staffing? Is it comparable to the banks, at 50 per cent, more or less?

Willie Watt: No, it is not, but the other thing that you need to take into account if you are looking in so much detail at Martin Currie is that it is owned by its employees. External parties own 25 per cent of the shares, but every person in Martin Currie, including the ladies on reception, is a shareholder in the company and we have a rule that no individual is allowed to own more than 7 per cent of the company. We are in a completely different situation from the banks because their shareholdings and bonus payments are divorced from each other. Most companies in our industry have a bonus pot based on a percentage of profits and they pay that out. That varies quite a lot depending on which company it is. I would not like to say what the right numbers are.

If you are asking me what the right numbers are for banks, we need to look at the shareholder returns and what is a competitive package for the banks' people. A competitive package for a branch manager on Princes Street will be a different thing from that of an investment banker who is based in London. If Stephen Hester were here he would say that he needs to ensure that he has the best people working in his branches on Princes Street and that he has the best people working in his investment banking business in London. He is trying to pay no more than enough to ensure that he can hold on to the best people in an industry in which people are mobile across the spectrum. The companies are trying to balance the requirement to make a return on capital and pay a dividend to their shareholders—they are not paying dividends at the moment, but they aim to do that in the long term—with appropriate rewards for their staff.

Ms Alexander: You talked about banks, but you have also said that most companies in the investment management industry have a formula of some sort for the percentage of profits that go on bonuses. Maybe you could tell us what that percentage of profits was for the past two years.

Willie Watt: I told you that Martin Currie paid no bonuses in 2009. Our bonuses are based on mechanical schemes that relate to objectives for each individual, from the receptionist up to the chief executive, so that each individual knows what they should earn. In 2008, we scaled bonuses back by 50 per cent, not because we could not pay them but because we saw that 2009 was going to be an uncertain year and we did not think it was right to pay them from the point of view of taking risk.

Ms Alexander: Were they deferred or were they simply cancelled?

Willie Watt: They were cancelled, but we issued more share options to our staff as compensation for the cancellation of bonuses. That made sense because our staff are all shareholders in the firm and, in the long run, the shareholders should benefit from the fact that the bonuses were not paid out.

Ms Alexander: What percentage of profits—

Willie Watt: Did we pay out? Probably 25 to 30 per cent.

Ms Alexander: And the compensation in share options?

Willie Watt: It is difficult to measure that because the benefit will be taken when the share options are exercised some years in the future, but about 1 per cent of the share capital of the company was issued in options.

Ms Alexander: You said that you paid out nothing in bonuses last year, and that in the previous year you paid out 25 per cent of profits directly, which is half the norm in parts of investment banking. Is that competitive for your industry?

Willie Watt: Yes. In clearing banking the bonuses are smaller than they are in investment management, and in investment banking the bonuses are bigger. We are in the middle of the industry.

Ms Alexander: Do you expect and would you welcome regulation in the area to try to introduce some industry benchmarks and deal with the anxieties that people have?

Willie Watt: One needs to ask what the anxieties are and whether they are appropriate. In relation to the investment management industry, I do not think that they are appropriate. I do not think that regulation would work unless it was global, because the best people are capable of working in many places and they would migrate over a period of years to other places. It would risk destroying the financial services industry here. The concern on bonuses should be driven towards things that have systemic risk. I do not think that the investment management industry has systemic risk.

Marilyn Livingstone (Kirkcaldy) (Lab): We have heard evidence across the board about the importance of being able to recruit and keep appropriately qualified staff. Are you able to draw sufficiently and appropriately skilled and educated individuals from the Scottish base?

Willie Watt: Yes, but there is an issue. The industry is concentrated in Edinburgh and there is a lot of competition for administrative staff and non-senior management, because both the asset servicing part of the industry and our part have been growing. The sector is concerned about whether there are enough skilled individuals available in the workforce to take up jobs as the sector grows. That concern was probably at its peak in 2007, but it has lessened since the crisis because, sadly, there have been redundancies, and people who have been made redundant in banking might be able to move into investment management in administrative and back-up functions.

There is a concern about skills in the long-term, but the sector has been working with the Scottish Government on that. There is also a concern about the competitiveness of Edinburgh as a location in terms of house prices and transportation. Many of our less well-paid staff find it quite difficult to own family accommodation in Edinburgh, which of course means that they must move further out. From a Scottish point of view, that spreads the benefit of the sector's jobs into Fife, West Lothian and Glasgow, but there are clearly issues with that from a transportation point of view.

10:30

Marilyn Livingstone: The committee will compile a report to the Scottish Government. What do you think should be our key recommendations to it on the subject of skills and education? What can the Government do in that regard?

Willie Watt: You will no doubt have come across an organisation called the Financial Services Advisory Board during your evidence taking. It has provided a very effective way for the sector and successive Governments to interact and work together and a number of initiatives are on-going. Much of that has to do with what the sector does to make careers in financial services and investment management attractive to people when they come out of university. One of the side implications of the crisis has been that young people are less attracted by the sector, because of all the things that have happened. I think that the sector probably has to do more about that than the Government.

The issue for the Government is just to ensure that people coming out of secondary school and university have the right kinds of skills and knowledge of the system, and that careers services in schools are equipped to guide people who wish to enter the sector. When I came out of school, working in the sector was perceived as a positive thing, and people wanted to go and work for companies such as Standard Life and Scottish Widows—it seemed an exciting thing to do. Some of that has gone because of the crisis, so we need to try to get it back. I am not sure that I could point to anything specific to financial services that would not relate to the general level of educational attainment that we would want anyway.

Marilyn Livingstone: Thanks for that. Has your company had discussions with FiSAB and the Scottish Government? If so, what form did they take? Were they about financial sector reforms?

Willie Watt: I was a member of FiSAB until about 18 months ago and I participated in discussions with the current and previous Administrations that covered a wide range of issues: education; transport; the planning system; the projection of Scotland as a financial services sector and what organisations such as Scottish Development International can do to attract companies to come and set up in Scotland; and what the Scottish Government might be able to do to showcase the sector's skills. I have found the engagement with successive Administrations to be very good.

As I said, I have worked in the sector for 25 years. In the 1980s and early 1990s, the Government's view was that the sector was big and ugly enough to look after itself and that any intervention should relate to failing industries. Many Government activities focused on shipbuilding, the steel industry and so on. That attitude has changed in the past 10 years. There is now a recognition that the financial services sector is an important employer in Scotland and an important part of the tax base for individuals and so deserves to be engaged with at a high level. Actually, the level of engagement has been good.

Marilyn Livingstone: My final question is on a more general point. Are there any long-term reputational issues for Scotland because of the crisis?

Willie Watt: I have been asked that a few times by various people. Because I am Scottish and we are based here and our business is international, I have looked for such issues as I have travelled the world, but I honestly have not found them. Clearly, people would say that some things that the big Scottish banks did might have been imprudent but, equally, UBS and AIG did imprudent things. Every financial sector in the western world, whether it be in New York, Boston, London or Zurich, has institutions that have been major casualties of the financial crisis. Many people that I come across also deal with those sectors. I do not think that people have singled out Scotland.

I am not in a good position to judge whether the man in the street in Zurich or New York has changed his view of Scottish financial services, but I think not. I sense that brands such as Scottish Widows and Standard Life are as strong as ever. The question is a good one and it is a good thing to worry about, but I have not personally seen that effect.

Stuart McMillan (West of Scotland) (SNP): I have a question about bonuses and another couple of questions. We heard in previous evidence about a campaign to stop bonuses at all levels. Earlier, you told us that 3,000 people work in the industry in Scotland and that a further 4,000 work in back offices. Would a cessation of bonuses have a massive effect on those people's standard of living, particularly those in the back offices who are less well paid? What would be the effect on the number of people going into the industry?

Willie Watt: Such a measure would have an impact on people's standard of living. Most people in the investment management industry, in all levels of companies, are paid bonuses that are based on performance. However, the large sums of money are paid to the more senior people, who are probably more able to have a year or two with no bonuses. The measure would impact on people's standard of living and the attractiveness of the industry for employment.

I presume that you are talking about banking, rather than investment management, but I think that employees would be confused about why they were being penalised for mistakes that had been made by people who are probably no longer involved in the organisation. That would probably mean that people would be less keen to work in financial services.

Stuart McMillan: My presumption was that it would apply throughout the financial sector, not just to one aspect.

Willie Watt: That would require an extraordinary piece of legislation, and it would risk destroying the UK as a financial services location. We have spoken about Scotland, but we are wired into the City, which is one of the two global hubs for financial services in the world, together with New York. The City is the location of choice for financial services outside the US, because of the time zone issue that I mentioned earlier and also because of the English language. A draconian set of policies on bonuses would carry a deep risk of destroying that position.

Stuart McMillan: You have touched on the global aspect of how we move things forward. Do you have any particular concerns about proposed European Union directives or regulatory changes more generally?

Willie Watt: There has been a debate in the Parliament on the alternative investment fund managers directive, and there are some issues around that about the reduction in choice that investors might face, as well as the increase in costs that would be associated with some of the proposed changes. There would also be a risk of retaliatory measures, as the directive is anti-competitive for non-EU—and particularly US—participants in the industry.

I have concerns about legislation. It is natural that Governments might wish to increase regulation, given the systemic failures that we have discussed. However, regulation must be well thought through. There was no consultation before the alternative investment directive was published. Those who formulated it would probably say now that they should have taken a little bit longer to get the formulation right, and to be clearer about what they were trying to achieve.

There is a further issue faced by companies in Scotland. Because we are so international in our operations, as I pointed out earlier, we must pay attention to what the SEC, the FSA and the European Union do with regard to regulation. If the various regulations are not integrated, there is a risk that they will be ineffective, and that they will lead to arbitrage when it comes to where companies locate, as they seek to take advantage of more lax regulation. Policy makers would not wish that to happen.

Getting global agreement on regulations is extremely difficult, because different policy makers have different objectives. Policy makers in the US and Europe tend to view the crisis slightly differently. There has been a much greater focus on bonuses in the UK than in other jurisdictions, for example. It is a big ask to reach consensus on global regulation, but it is worth it—that should be the objective.

Stuart McMillan: The committee has heard a number of people raise concerns about a one-size-fits-all strategy. I fully appreciate that it will be extremely difficult to reach a global solution, but if there were such a global solution, it could well have an impact on businesses, companies and industries in nation states. Potentially, one size fits all might not be a successful approach.

10:45

Willie Watt: I agree. What concerns me most is that, as this discussion has made very evident, the systemic risk has been with banks—indeed, a particular type of bank. Many questions have been aimed at Martin Currie and the rest of the investment management industry about what we do, our bonuses and so on, but the fact is that we do not have those systemic risks. Regulating investment management firms in exactly the same way as banks would be a big overreaction to where the systemic problems actually lie. Policy makers must decide exactly what they want to achieve through regulation, find out where risk lies in the financial services system and then focus on it. Given that risk lies neither in the life assurance or investment management parts of the sector, nor in high street banking or banking for small and medium-sized enterprises, but in the strategic management of the big global banks' investment banking activities, that is where regulation should be focused. If we narrow the scale of the problem that you alluded to, there is more chance that the vast majority of companies around the world will not feel its impact and we might also be able to define things such that we might be more likely to build an international consensus around them. I am not sure, however, whether that answers your question.

Stuart McMillan: What policy decisions would you like to be made about areas where systemic problems exist?

Willie Watt: As I said earlier, we need to reach a consensus view on the amount of risk that we are prepared to allow organisations whose failure would create systemic risk and then define the parameters of those businesses in relation to the appetite for risk. Of course, that will require agreement on a number of measures of risk. Banks are complicated beasts and we cannot take such things forward solely on the basis of the debt-to-equity ratios on their balance sheets. That would be one commonsense measure, but there would have to be others. One way of putting together a set of measures would be to get global regulators to agree what that might look like. However, a current issue in the US is that all the companies with systemic risks are banks; those that were not, such as Goldman Sachs, had to become banks to get federal aid. Although such companies might well cease to be banks at some stage, that does not mean that their potential for systemic risk also ceases. As a result, any approach would have to capture organisations with such risk, but, as I say, it would also need a shared sense of the key measures of risk, which might include proprietary trading, debt-to-equity gearing levels, the complexity of financial instruments and the scale of the books of those instruments. I have to say, however, that I do not feel competent enough to come up with a full list.

Lewis Macdonald (Aberdeen Central) (Lab): Earlier, you said that the attraction of Australia for a company such as Martin Currie is the optimistic attitude there, which contrasts with the risk aversion that you now find in the UK and the US. Do the various levels of confidence in the world economy make the process of finding an effective regulatory framework more difficult or do they make it impossible? Is it a doable task?

Willie Watt: That is a good point. It makes it more difficult. Australia would be less willing to constrain its banking system than we, the US or countries in the European Union would be.

At the moment, the vast majority of global financial services, by market capitalisation or any other measure, are focused in the west—the US and the EU—but the growth is in the east. If Australian and Asian banks had a much more lax regulatory regime than European and American banks, they would use that, in the long term, to build competitive advantage against institutions that are based here.

Further, Standard Chartered Bank and Hong Kong and Shanghai Banking Corporation are based here, but have major business dealings in Asia. I have no evidential basis for my view, but I believe that if the regulatory environment were radically different they could move their domicile elsewhere. Regulation needs to be global, but that is an extremely difficult thing to achieve.

Lewis Macdonald: Given that difficulty, is the set of reforms that have come forward in the UK around the FSA and the management of the tripartite system compatible with a hypothetical global agreement on an overarching regulatory framework for international banking?

Willie Watt: I am not an expert in banking at all, but I think that it is. A lot of what has been talked about has been common sense. When I started out in financial services, the Bank of England was the dominant regulator, and the regulatory framework was quite simple. The situation has become much more complicated as time has gone on. The reform of the relationship between the Bank of England, the FSA and the Treasury was necessary and my guess is that it will work a lot better than before.

There is another issue, which is that the financial services sector is probably more important to the UK than it is to some other European countries. In the EU, change can be driven from a wide range of starting points, so it is important that we ensure that the UK's place at the

European table is assured when we are dealing with things such as the alternative investment directive. The FSA's view on that would be quite different to some of the ideas that are being put forward in Brussels.

Lewis Macdonald: So effective representation is critical at whatever international forum might be relevant.

Willie Watt: Yes.

Lewis Macdonald: With regard to your sector's approach to risk management and mitigation, are there any lessons for public authorities to draw from your sector that might have relevance for the banking sector?

Willie Watt: That is a good question, and I am not sure that I know the answer to it. One of the things that our sector got wrong some years ago involved issues around split capital investment trusts and the misselling of investment products, which happened because those products were not described in a way that the man in the street could understand. The investment management industry did a lot of work to ensure that what it did was understandable to the man in the street and that the language that we used was more straightforward.

In a funny kind of way, that needs to be applied at the corporate level to the way in which banks talk about their businesses, given how important they are within the overall framework of risk. That is not an easy thing to do, but, in the past year or two, the issue of financial literacy has got a hell of a lot more important to everyone than it was before.

Lewis Macdonald: That is something for the banking sector to do, which the regulators could support.

Willie Watt: Yes, and the regulators need to ensure that everyone communicates in a way that people understand. If people do not understand what is being talked about, they will not gain sufficient confidence when things are put right. Things must be seen to be put right once they have been put right, which is quite difficult.

Christopher Harvie (Mid Scotland and Fife) (SNP): You say that the language of finance was simplified and made more accessible after things such as the split capital investment trusts business, which I think took place in 2003. That was the situation that famously involved an FSA report coming out on Christmas eve—am I right?

Willie Watt: I think so. Possibly.

Christopher Harvie: That is another way of burying bad news effectively. I think that it happened during the FSA's light-touch days.

Do you accept that the simplification of language does not seem to have been very successful, in that the particular crisis that it was used to deal with was followed by a crisis of a much greater degree of magnitude?

Willie Watt: That is true, but the issues around the descriptions of investment products and their risk framework involved a retail risk for the man in the street. The misdescription of risk in the financial crisis was driven less by language and more by the mathematical scoring of risk, which turned out to be ineffective, and the rating of risk, which turned out to be misleading. That is particularly true in relation to debt-based and bond-based products with, initially, mortgages as their underlying substance. The first-rate victims of problems with those two issues were institutional. That comes back to what I said earlier about the clients and the people who sold them products sharing a sense of what was meant by the financial and mathematical formulae that detailed risk and by Standard & Poor's ratings. Of course, that understanding turned out to be wrong.

There are some excellent books about the recurrence of factors within bubbles in the financial world that detail the terrible things that can occur, going all the way back to the south sea bubble in the 18th century. One of the key factors of a bubble is that everyone starts to think the same way. That behavioural element of a bubble is based on belief and sidesteps logic in a way that becomes apparent only after the crisis. Therefore, this time around, faced with a choice between blaming language or maths, I would probably blame maths.

11:00

Christopher Harvie: Do you find that the graduates whom you recruit and whom you are anxious to keep from heading off to Bermuda are adequately schooled in the social implications of economics, or are they far too heavily indoctrinated with mathematical formulae?

Willie Watt: That is a very good question. It is the duty of employers to educate their staff about the social implications of what they do. We try to do that in our company, and I know that other companies try to do that, too. One way that we do that is by ensuring that employees have strong opportunities to volunteer in non-financial services contexts. We are based in the centre of Edinburgh, and we work with a local primary school. We have a big foundation that supports charities, and we do a lot of fundraising work. We and our employees believe that there is more to working in the sector than just punching numbers and picking up pay cheques.

There is another element to your question. If a person works in a business that is capable of producing systemic risks, they have a social and an economic responsibility. I would expect that point to be driven home in the large banking institutions, and I am sure that it is. There must be a social element to their attitude to risk because of the important place of banks in a much bigger system.

Christopher Harvie: I think that if you asked people in Scotland about the matter, they would still link the North Sea oil experience and the role of investment banking in setting that up. We went out to the Shearwater rig, which is principally a gas rig, and the experience was most unpleasant; it was frightening. Around a fortnight later, a helicopter on the route came down, and everyone in it was killed. People said, "It's no fish you're catching; it's men's lives." It seems to me that you depend on people doing very dangerous jobs, but you are in a room with no communications to the outside world, except through your computers.

You have mentioned Australia and China as being lively and optimistic areas for finance and economic development. If you were to subtract from their economic relationship China's enormous dependence on raw materials—iron and coal, principally—would there be a financial sector there of such liveliness?

Willie Watt: In China?

Christopher Harvie: Yes, or Australia.

Willie Watt: Probably not—or yes and no. It is clear that the resources sector is extremely important to China and that the linkage between Australia and China is driven by resources, as you say. Your North Sea analogy plays out. The benefits to broader society in Scotland as a result of having a resources-based economy have been great. Jobs have been created outside the resources sector; the same is true in Australia.

In China, the resources are needed because there is a massive political imperative to spread opportunity and wealth throughout a large population, which requires concrete and steel. China recognises that it cannot have a rich eastern seaboard and a very poor central and western area, because that is not politically sustainable, even within a one-party system.

Yesterday, I was in meetings in London to talk about China. The imperative is to improve health care and social security so that the Chinese consumer can spend. The Chinese are great savers, because they have to save. They do not have the same welfare net that we have here. If they are going to consume more, they need to be confident that there is more provision. The reaching out that has to be done requires steel and coal. China has sufficient momentum that that would happen anyway. That has a pull-through into Australia, the risks of which are more political than anything. If China went into a period of low growth or decline, that would have a direct implication for Australia.

Christopher Harvie: I have one observation and one final question.

The Convener: Can you move straight to the question, please?

Christopher Harvie: Yes. The Chinese advance is really like something out of the 18th century—it is really Adam Smith economics. Our very sophisticated financial system loaned billions and billions to, in effect, Homer Simpson, who lies at the end of all these complicated machines. That is the observation.

Within 20 years, we will be in peak oil—we will be handling something like $200 a barrel, at least. There is a great opportunity for Scotland in the sources of power in the North Sea and the possibilities of burying—carbon capture and storage schemes. We have a marvellous and unending opportunity. What can the financial investment industry bring to that? It was able to bring something to the North Sea in the 1970s.

Willie Watt: Energy is one of our investment specialisms at Martin Currie, and we have a team of people who invest in the global energy sector. One of the product areas that we are considering launching is renewable energy. We think that investors around the world are interested in renewables as an investment proposition as well as because they are a good thing to control carbon and all the rest of it.

Capital can be brought to bear by the sector—as it was for oil exploration in the North Sea, which was successful for the sector and for investors—by specialists who are knowledgeable enough to be able to convince themselves and less knowledgeable investors that there is something to be done there.

Our approach will be global, but equally it will enable Scotland to be put in a sensible context. As we know, there are big advantages for Scotland in relation to renewable energy. If oil goes to $200 a barrel, the oil province in the North Sea will be much more feasible than it is at the moment. The areas to the west of the Western Isles, which have not been looked at much, might be much more viable. With higher energy prices, energy will definitely be a core sector for Scotland. Our sector's job is not to support the energy sector because it is "a good thing" but because it will make sense for pension scheme investors and the individuals whose money we manage.

The Convener: I return to a point that Chris Harvie made at the beginning of his questions, relating to the use that financial institutions, especially banks, make of credit rating agency ratings. It has been suggested that there was overreliance on and, perhaps, misuse of such third-party ratings, instead of due diligence on some of the instruments that were traded. Do you share that concern?

Willie Watt: There was probably overreliance on ratings and insufficient due diligence on the Homer Simpson point. Homer Simpson is probably a reasonable credit risk, because he has a good job. However, people who were not good credit risks were able to access mortgages that did not make sense. Those mortgages were packaged and sold on to investors with an insufficient sense of the risk in such packages. The more liquidity there is in the system, the harder it is for the end buyer to do the diligence. It was not unreasonable for the end buyer to rely on the diligence that was done by the investment banks that packaged the products, but that diligence was not sufficient. There was a failure both in the investment banks and at the front end, where organisations sold mortgages to people who did not meet the criteria that the end investors were told were part of the package. There were failures in a number of areas of the system. Clearly, there were failures in the rating agencies, which were the independent assurance in the system.

The Convener: Thank you for the helpful answers that you have given during this lengthy evidence session. We will try to reflect them in the final report, which the committee will consider shortly.

Willie Watt: I am sorry if I talked for too long.

The Convener: That is not an issue—you were answering questions that we put to you.

Willie Watt: I did not understand some of the numbers that Ms Alexander cited. I would like to have an opportunity to write back to the committee with a better answer than I was able to give.

The Convener: We will check the source of our information and forward it to you, so that you can comment on it.

Willie Watt: I will do so.

The Convener: That would be helpful to the committee.

Ms Alexander: Any revisions to the *Official Report* that would be appropriate can be made in the light of that. The numbers that I cited came from an official briefing to the committee. For example, the figure that I gave for operating profit in 2003, based on returns to Companies House, is a matter of fact. It would be helpful if you could clarify the matter.

The Convener: That concludes evidence taking for our inquiry. Before we go into private session, I draw members' attention to an article that appeared in the business section of this week's edition of *The Sunday Times*, which claimed that sources close to the Economy, Energy and Tourism Committee had revealed certain recommendations in our draft report. As convener, I make clear that there are no recommendations from the committee until such time as we have agreed and published our final report.

The committee has already agreed to consider its report and recommendations in private. I remind members that paragraph 7.4.2 of the code of conduct for members of the Scottish Parliament clearly states:

> "All drafts of committee reports should be kept confidential, unless the committee decides otherwise."

The purpose of that provision is to ensure that the committee is able to have full and frank discussions on a range of possible recommendations that may be contained in a draft report. It is not only a breach of the code of conduct but a discourtesy to other members of the committee to discuss such reports with journalists. I deplore the behaviour of the so-called source or sources of Sunday's story and hope that there will be no repeat.

11:15

Meeting continued in private until 13:36.

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