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C1 CURRENCY RECOMMENDATION

- The Commission recommends that the currency of an independent Scotland should remain the pound sterling for a possibly extended transition period.
- A future Scottish Government should put in place the arrangements and financial infrastructure that would support a move to an independent Scottish currency at such time as this was considered appropriate for the Scottish economy.
- What happens with respect to currency the day before an independence vote would happen the day after and continue to happen until such time as the elected Scottish Government seeks to do something differently.
- The Commission recommends that a decision to move to an independent Scottish currency should be based on a governance process and criteria set out clearly in advance of voters making a decision on independence. Such an approach is a necessity to maximise certainty and stability, and to minimise risks. We recognise that this means that the Scottish Government would not secure monetary policy sovereignty in the initial period following an independence vote though the Scottish Government would not be in a formal monetary union.
- This option allows the focus of the government, individuals, investors and businesses to be on policy choices for growth and the sustainability of public finances and the development of necessary institutions. It also removes a range of uncertainties concerning existing arrangements and contracts.
- We note with some interest that this was the approach taken by Ireland for an extended period, albeit in a different period of history.
- The existing financial assets and liabilities of Scottish residents, and the financial assets and liabilities which residents of countries outside Scotland hold with Scottish institutions, are assets and liabilities of these individuals, businesses and institutions, not assets or liabilities of the Scottish Government, before or after independence.

C1.1 Part of the Commission’s brief was to take account of the recommendations of the 2013 Fiscal Commission reports, and the outcome of the EU referendum, and consider the most appropriate monetary policy arrangements to underpin a programme for sustainable growth in an independent Scotland.

C1.2 We have thoroughly reviewed the extensive work that was undertaken by the Fiscal Commission, as well as the headline recommendations that were made. Most of the detailed work that was undertaken, including the details of institutional design, remains valid and we see no need to repeat it – it will be available to those tasked with setting up the new institutions.
This report therefore focuses on areas where the Commission believes that there is merit in taking a different approach, and on addressing questions that may be in the minds of businesses and individuals that wish to understand the implications of what is being recommended.

The recommendation of the Fiscal Commission in 2013 was to continue the currency union with rest of the UK. The rationale was that sterling was the currency that fits the optimal currency area criteria best between Scotland and the rest of the UK. There was also an explicit recommendation to allow a change to a more flexible regime in due course, when economic conditions suggested that it would be in Scotland’s interest to do so (Scotland’s Future p111). However, during the 2014 independence referendum, the UK Government rejected the proposal for a formal currency union. While it remains a feasible outcome for both Scotland and the rest of the UK, it would create too much economic uncertainty for the formal currency union policy to be part of the proposition in a future referendum, since it is possible that a future UK Government could take a similar obstructive position. The blocking itself created unnecessary confusion and uncertainty for individuals, businesses and investors.

The case for a sterling currency union remains strong since Scotland and the rest of the UK remain a close approximation to an optimal currency area and would continue to be so for some years after Scotland became independent. It would also provide continuity and stability. That said, critics argue that it would mean that Scotland’s government would cede effective sovereignty over monetary policy while the rest of the UK would become exposed to the financial policy actions of the Scottish Government.

It would be in the interests of both Scotland and the rest of the UK for existing and new institutions to work closely together during and after the transition to independence, and that is what we would expect to happen. However, unlike in 2014, the recommendations set out in this report do not require the pre-agreement of the UK Government or UK institutions.

Recommendation: The certainty and stability of ‘Sterling Continuation’

The Commission recommends that the currency of an independent Scotland should remain the pound sterling for a possibly extended transition period.

In the longer term, if it were in the rounded economic interests of Scotland to develop its currency arrangements Scotland would, of course, be able to introduce its own currency. The Commission recommends that such a future decision should be based on a formal governance process and criteria set out clearly in advance of voters making a decision on independence. Such an approach is an absolute necessity to maximise certainty and stability and to minimise risks.
C1.9 We recognise that this means that the Scottish Government would not secure monetary policy autonomy in the initial period following an independence vote. Our view is that the advantages of stability from retaining Sterling outweigh the benefits of introducing a new Scottish currency, at least in this initial period in the short to medium term.

C1.10 This option is not ‘sterlingisation’ (since Scotland already uses Sterling) and allows the focus of the government, individuals, investors and businesses to be on policy choices for growth and the sustainability of public finances. It also provides certainty and continuity concerning existing arrangements and contracts.

C1.11 We note with some interest that this was the approach taken by Ireland for an extended period, albeit in a different period of history.

**Background: Role of Currency**

C1.12 The functions of money are traditionally defined as those of medium of exchange, unit of account, and store of value. The medium of exchange describes the way in which people make everyday transactions. Traditionally they did so with coins but in the nineteenth century fiat money, paper issued (mostly) by state agencies, became dominant. The medium of exchange is a natural monopoly; there is a strong tendency for only one kind of paper or coin to be used for transactions in any one jurisdiction. It is, however, important to note that today cash is only used in a minority of transactions and accounts for only a small proportion of the total value of transactions. The natural monopoly of medium of exchange does not apply in the same way to electronic transactions as it does to cash transactions.

C1.13 The unit of account is the basis on which people make contracts with each other, keep accounting records, and plan budgets. Most businesses and some individuals employ several different units of account because they deal with many different customers and trade internationally. As a result, they deal in several currencies and if they prepare formal accounts they aggregate their different currencies for reporting purposes.

C1.14 Money also acts as a store of value. Businesses and households make deposits with banks and other financial institutions and invest for future needs and for retirement. This activity was once local - deposits were held in local banks and if investment was made in stocks or bonds such investments were generally in locally based corporations. But both banking and investment are now conducted globally. The majority of deposits and investments are private contracts and the underlying value of the investment depends on the terms of that private contract, not on any government decision.

C1.15 Unlike households, when states borrow on international markets they tend to borrow in widely used global currencies such as US dollars, euros, sterling or yen.

C1.16 ‘Legal tender’ is now a concept of no practical significance - as demonstrated by the fact that the only ‘legal tender’ in Scotland today is coin. As a medium of exchange, people
use whatever medium of currency or currencies are generally accepted, which is why both Bank of England and Scottish bank notes are universally accepted in Scotland although neither are legal tender, and why Scottish bank notes are widely if not invariably accepted in England, though only Bank of England notes have legal tender status there.

C1.17 As a unit of account and store of value, businesses and individuals will use whatever is appropriate for their needs. Today we live in a global world, which allows considerable freedom for these businesses and households to determine what is appropriate to their own needs. Businesses which are outside the Eurozone or United States make contracts with each other in euros and dollars and choose to do so (or not) under English or US law and may use these currencies and legal systems for agreements that do not involve the US or UK in any way. Dollars, and to a lesser extent Euros, are widely used by individuals outside the United States and Europe and in many countries prices of large or tradable items are quoted in dollars even though payment will be made in local currency. Many businesses and individuals have bank accounts and other assets and liabilities in currencies which are not the currency of the country of which they are citizens or in which they are resident.

C1.18 Shares are quoted on stock exchanges in currencies which may or may not be the currency of the country in which that exchange is located and which may or may not be the currency of the country in which the company is registered. Other investments - unit and investment trusts, long term insurance contracts, pension funds - will generally be made in the securities of global companies which trade internationally and whose value depends on global economic developments, a value which will be translated into the local currency of choice at the time at which the holder wishes to sell the investment or draw his or her pension.

C1.19 Cash is of diminishing importance in everyday transactions. The value of physical sterling cash outstanding today is less than 5% of total UK Government debt. Cash balances have not generally been falling as a share of GDP, which seems puzzling given the shift to plastic and electronic transactions in everyday life. But there is growing evidence that much of the physical cash in circulation is associated with hoarding or illegal or semi-legal transactions. Cash circulating, or at least outside the banking system, in Scotland today is approx. £6-7 billion, more than £1000 per person living in Scotland, roughly equally divided between Scottish bank notes and Bank of England notes.

C1.20 There is no need for a formal monetary union between Scotland and the rest of the UK to enable Scottish businesses and residents to continue to use the pound sterling. In today’s world, no one ‘owns’ a particular currency and the more widely acceptable the currency the less the issuer is able to restrict its use. What happens with respect to currency the day before an independence vote would happen the day after and continue to happen until such time as the elected Scottish Government seeks to do something differently.
In a trading economy, the only restrictions an issuing authority can place on its own currency is to deny outsiders any influence over setting interest rates, or deny membership of its banking union, or supervision and regulation schemes or clearing system. Scotland, a small part of a global capital market, would have little influence on interest rates, even within Scotland, under any imaginable regime consistent with financial stability. An independent Scotland would operate its own banking regulation, in line with international norms and agreements, and (for Scottish retail banks) its own resolution scheme. To the extent necessary, an independent Scotland could operate its own payments clearing system.

Governments which issue currency benefit from seignorage; notes are debt which is unlikely to be repaid (although holders can in effect insist on repayment by tendering the notes in payment of taxes or other obligations to the state). Initially Scotland could not enjoy such seignorage profits, although the amount at issue is small relative to the scale of government activity - as noted above, note issue is less than 5% of UK debt and at current interest rates the annual value of the perpetual interest free loan of £4 billion to the Bank of England, of which the current use of Bank of England notes in Scotland represents less than £100 million.

The issue of notes by Scottish banks could continue on the present basis, under which they are backed pound for pound by Bank of England notes and deposits. For technical reasons, Scottish banks would thereby retain some seignorage benefits. At independence, the requirement to deposit Bank of England notes at the Bank of England would become a requirement to deposit Bank of England notes with the Scottish Central Bank. The notes would of course remain the property of the banks depositing them. The Scottish Government might in due course undertake issuance itself, initially with similar backing by Bank of England notes or deposits. As people became used to the arrangements and the security of the currency, such backing could probably be reduced.

We expect that there to be a cordial and constructive relationship between the Scottish Central Bank and the Bank of England, and it would clearly be in the interests of both parties and both countries to establish and maintain such a relationship.

As a result of the development of global capital markets and electronic transfer it is now virtually impracticable for an open economy to impose effective capital controls in the medium or long term. Scotland should not impose or attempt to impose restrictions on the movement of capital to or from Scotland.

It cannot be emphasised too strongly that the existing financial assets and liabilities of Scottish residents, and the financial assets and liabilities which residents of countries outside Scotland hold with Scottish institutions, are assets and liabilities of these individuals, businesses and institutions, not assets or liabilities of the Scottish Government, before or after independence. There is thus no benefit, and a considerable downside, for a future Scottish Government to seek to legislate to change the terms of these private contracts.
Scotland were to adopt a distinctive Scottish currency in future, that currency would be incorporated in future contracts - not in past or uncompleted ones.

C1.27 Any legislation a future Scottish Government might promote to alter existing contracts would be subject to the protections against expropriation of property in Article 1 of the European Convention on Human Rights (ECHR). The government of an independent Scotland would apply to become a member of the Council of Europe and it can be assumed that the application would be successful (the ECHR is governed by the Council of Europe, which has 47 members, including many countries outside the EU). The constitution of an independent Scotland should provide for protections of property rights at least as strong as those implied by the ECHR. Scotland would also be bound by its membership of other international institutions such as the IMF and whatever trading arrangements were negotiated with the rest of the UK, the EU, and other countries.
C2 TESTS FOR FUTURE CURRENCY OPTIONS

- The arrangements supporting the Scottish currency and the Scottish financial system should allow for the possibility that the Scottish Government may choose to establish a separate currency at some future date.
- In order to secure maximum long-term certainty, we recommend that the governance and rules by which any future choice could be taken are set in advance.
- The introduction of a separate Scottish currency would be subject to six tests, an assessment of which would be made by the Scottish Government and put to the Scottish Parliament for approval:
  1. Fiscal sustainability: Has the Scottish Government sustainably secured its fiscal policy objectives and sufficiently strong and credible fiscal position, in relation to budget deficit and overall debt level?
  2. Central Bank credibility and stability of debt issuance: Has the Scottish Central Bank and Government framework established sufficient international and market credibility evidenced by the price and the stability of the price of its debt issuance?
  3. Financial requirements of Scottish residents and businesses: Would a separate currency meet the on-going needs of Scottish residents and businesses for stability and continuity of their financial arrangements and command wide support?
  4. Sufficiency of foreign exchange and financial reserves: Does Scotland have sufficient reserves to allow currency management?
  5. Fit to trade and investment patterns: Would the new arrangement better reflect Scotland’s new and developing trading or investment patterns?
  6. Correlation of economic and trade cycle: Is the economic cycle in Scotland significantly out of phase with that of the rest of the UK, or at least as well correlated with the cycles of other trading and investment partners, thus making an independent monetary policy feasible and desirable?
- The conditions and rules that would determine a change of monetary policy and currency choice should, as articulated in this chapter, be made very clear in advance. In the event of a new Scottish currency being created it is likely that a period of 1:1 pegging with sterling would make sense for the short and possibly medium term.

C2.1 The continued use of sterling is the best method of achieving the critical objective of ensuring stability and continuity of financial affairs for Scottish businesses and Scottish residents, covering both trade and investment, in the initial period after independence.
C2.2 The arrangements supporting the Scottish currency and the Scottish financial system should enable the Scottish Government to choose to establish a separate currency at a future date. However, this should not be taken as an indication of any commitment to do so.

C2.3 Even if there were to be such a currency change, many individuals and businesses in Scotland would be free to continue to do business and transact many or most of their financial affairs in sterling and might choose to do so.

C2.4 However, in order to secure maximum long-term certainty, we recommend that the governance and rules by which any future choice could be taken are set in advance. This way the credibility and policy certainty required by individuals, companies and investors could be secured.

C2.5 The objective of monetary policy and strategy should be to:

- secure stable monetary unit with low inflation;
- secure an exchange rate regime appropriate to the needs of the Scottish economy;
- enhance the development of Scotland’s economic and trading relationship with the rest of the UK, EU and international partners;
- minimise inconvenience, uncertainty and transactions costs for individuals and businesses.

**The proposed Six Tests**

C2.6 Any proposed change, and in particular the introduction of a separate Scottish currency, would have to be justified by its ability to meet these needs more effectively. The review would therefore focus on six tests:

1. **Fiscal sustainability**: Has the Scottish Government sustainably secured its fiscal policy objectives and sufficiently strong and credible fiscal position, in relation to budget deficit and overall debt level?

2. **Central Bank credibility and stability of debt issuance**: Has the Scottish Central Bank and Government framework established sufficient international and market credibility evidenced by the price and the stability of the price of its debt issuance?

3. **Financial requirements of Scottish residents and businesses**: Would a separate currency meet the on-going needs of Scottish residents and businesses for stability and continuity of their financial arrangements and command wide support?

4. **Sufficiency of foreign exchange and financial reserves**: Does Scotland have sufficient reserves to allow currency management?
5. **Fit to trade and investment patterns**: Would the new arrangement better reflect Scotland’s new and developing trading or investment patterns?

6. **Correlation of economic and trade cycle**: Is the economic cycle in Scotland significantly out of phase with that of the rest of the UK, or at least as well correlated with the cycles of other trading and investment partners, thus making an independent monetary policy feasible and desirable?

C2.7 An assessment against these tests would be made by the Scottish Government and put to the Scottish Parliament for approval.

C2.8 Given the need for a transition period, the need to build institutional capacity and the timescales associated with establishing fiscal credibility (see the recommendations in Part B of this report), we anticipate that these six tests are unlikely to be met until towards the end of the first decade following a successful independence vote. However, it is possible that we have underestimated the economy’s growth performance and potential and it will occur more quickly.
C3 SCOTTISH CENTRAL BANK & SCOTTISH FINANCIAL AUTHORITY

- The Commission recommends that two new institutions are set up, the Scottish Central Bank (SCB) and a Scottish Financial Authority (SFA), which would be a wholly owned independent subsidiary of the Scottish Central Bank.
- These new institutions should be created to provide the governance, necessary functions, structures and approaches of the existing UK institutions. The resourcing, scale and less complex nature of Scottish institutions would reflect the simpler structure and the different composition of the Scottish financial system.
- The Scottish Central Bank would assume final responsibility for the functions, in Scotland, of the FCA and the PRA in the UK through its SFA subsidiary (including both banking and insurance supervision).
- It would act as banker to the Scottish Government, and hold deposits and provide liquidity support, subject to the asset and collateral requirements, for Scottish retail banks, to the extent necessary to protect retail depositors. The SCB would operate a clearing system for these banks. It would also establish a Scottish Financial Services Compensation Scheme similar to the UK FSCS.
- As a result there is no reason why Scottish businesses and individuals should expect to borrow on terms in any way different from their rest of UK counterparts.
- Banks operating in Scotland with Scottish headquarters or through Scottish subsidiaries (and hence regulated by the SCB) would be required to ring-fence their retail banking operations along the same lines as now proposed for the UK. The SCB would put in place a resolution regime similar to that in the UK for the orderly winding down of failed banks. Financial support from the SCB would not extend to the holding companies of retail banks to cover activities outside Scotland, or beyond what is needed to ensure that retail depositors in Scottish banks are protected. It is anticipated that a number of banks may re-domicile their registered headquarters to London. A substantial part of the executive functions of these banks is already in London and so there would be a very limited impact on operational activity.
- The supervisory culture and institutional structures in Scotland will remain closely aligned with the arrangements for the rest of the UK and Scotland should aim to become a natural bridge between the rest of the UK and the EU.
- The SFA will focus on all other parts of the financial sector in Scotland.
- It is anticipated that it would operate a unitary regulatory model combining prudential and conduct regulation.
- The transition arrangement should seek to ‘grandfather’ as much as possible from the UK arrangements.
Principles of Scottish Financial Regulation

C3.1 The objectives of financial regulation in Scotland should be to:

- provide stability and continuity up to and after independence for Scottish providers and all users of financial services.
- protect Scottish consumers, savers and investors;
- promote Scottish financial services internationally;
- develop a financial sector that best serves the needs of the Scottish economy.

C3.2 To achieve these objectives, regulations should seek to repair the damage done to the financial sector’s reputation for honesty and prudence in financial services by the failures that became evident in the UK banking system in 2008.

C3.3 These objectives can be met by pursuing equivalence - to licence companies to operate in Scotland provided their home country meets appropriate regulatory standards, and to expect other countries to offer similar freedom to Scottish companies operating in their jurisdictions. Equivalence has a specific technical meaning under current EU practice. The reference here is to the general principle rather than a particular rule. Debate over equivalence will be a key part of the Brexit negotiation.

Institutional Arrangements

C3.4 All financial systems require oversight by public authorities to set the rules for financial institutions and to ensure they are enforced. The functions that may be performed by the public authorities, in Scotland and elsewhere, include:

- regulate banks, primarily to ensure there are adequate capital and liquidity standards, drawing on international standards;
- authorise and supervise banks, to ensure they meet these regulations, have good governance and sound risk management, including for how they lend;
- oversee the payments system, to ensure it operates efficiently and serves the needs of the economy without disruption;
- act as a lender of last resort to individual banks that have a liquidity (rather than a solvency) problem, or provide emergency liquidity assistance to the banking system where there is a systemic need;
- provide deposit insurance, to ensure that retail customers of banks are protected if a bank gets into difficulty;
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- resolution of banks that are insolvent, in a way that protects financial stability and the real economy, while minimising the exposure of taxpayers.

C3.5 In the UK, the Bank of England has the sole or primary responsibility for exercising these functions. In some cases, this is done through the Prudential Regulation Authority, a wholly owned subsidiary of the Bank of England, or in conjunction with other public-sector bodies, such as the Financial Services Compensation Scheme, which is responsible for administering deposit insurance. The Bank of England also operates in a wider global framework including the Bank for International Settlements rules for capital adequacy, transparency and risk management.

C3.6 The Commission recommends that two new institutions are set up, the Scottish Central Bank and a Scottish Financial Authority (which would be an independent wholly owned subsidiary of the Scottish Central Bank).

Transition and Implementation

C3.7 New Scottish institutions could be created to provide the governance, necessary functions, structures and approaches of the existing UK institutions. The resourcing, scale and less complex nature of Scottish institutions would reflect the simpler structure and the different composition of the Scottish financial system. In the case of banking, for example, when compared with London and the rest of the UK, there are fewer international banks and a higher proportion of banking activity is retail (providing banking services to individuals and businesses) rather than wholesale (providing services for other financial institutions).

C3.8 The priorities for action are described below.

- To establish, during the transition period before independence, a new institution which would at independence become the Scottish Central Bank and would assume final responsibility for the functions, in Scotland, carried out by the FCA and PRA in the UK (including banking and insurance/pension supervision). These functions are described more fully below. To maintain equivalence, the Scottish Central Bank would need to build expertise and establish close contact with regulators internationally, especially in London, Europe and the United States.

- To adopt, at independence-day, the existing FCA and PRA rule books (substantially implementing European regulation) in Scotland as the starting point of a Scottish regime of financial regulation, and to be developed in line with changing rest of UK and international requirements.

- In the early years of independence, the overriding need for stability and continuity means that equivalence would have the highest priority. As confidence in the capacity of the Scottish Government and the Scottish Central Bank grows, however, the Government and Bank will wish to review financial regulation in the light of the overall...
needs of the finance sector and its customers and the requirements of the Scottish economy. Any such developments would follow extensive consultation and it is hoped that over time there would be opportunities for substantial simplification, while maintaining the fundamental objectives of equivalence and protection for Scottish consumers and the customers of Scottish businesses.

- To establish a Scottish Financial Services Compensation Scheme similar to the existing UK Financial Services Compensation Scheme - providing full coverage for insurance claims and coverage up to £85,000 for other financial services claims, including those of bank depositors. This should be a seamless transition from the UK to the Scottish scheme, so that there is no gap in coverage for depositors.

C3.9 The Scottish Government would also seek to negotiate a single arrangement for the joint regulation of occupational pensions with the rest of the UK, since so many schemes are UK wide. But, if such an agreement cannot be achieved, it will establish a Scottish pension regulator and pension protection scheme. In the interest of stability and continuity, a Scottish pension regulator would at independence adopt the rules and practices of The (UK) Pension Regulator and the current UK protection scheme but in view of the limited base to which a Scottish protection scheme would have access would consider finding some further mechanism of guarantee.

**Functions of a Central Bank**

C3.10 A stable financial system is an important part of overall macroeconomic stability and growth. Moreover, as became clear during the financial crisis, inadequate mechanisms to ensure financial stability can lead to banks that are “too big to fail” and to serious moral hazard issues that generate risky banking behaviour and sovereign risk that become correlated. Funding gaps between private savings and investment, between public spending and revenues, and between currency inflows and outflows, mean that loans and borrowing in one sector often drive loans/borrowing needs in another sector - making risk in the recipient sector extremely difficult to control. These risks need to be addressed and separated.

C3.11 A number of reforms have been made in advanced countries to reduce the risk of bank failures spilling over into the real economy, and to break the link between government and bank balance sheets. These measures include strengthening capital requirements, reforms to the structure of the banking sector, and new resolution tools.

C3.12 As part of these reforms, many central banks have acquired a stronger role in the oversight and delivery of financial stability. Most now have additional responsibilities for regulation and supervision, as well as tools to help deal safely with troubled or systemically important failing financial institutions. For example:

- Setting macro-prudential regulation standards (setting capital and liquidity ratios) to achieve and maintain financial stability;
• Regulating and supervising important financial institutions including the non-bank institutions;
• Preparing of resolution plans/strategies, including co-ordination across states for significant cross-border institutions;
• Providing extended liquidity facilities;
• Implementing resolution plans for troubled banks and other financial institutions including international agreement on how to ring fence (“re-domicile”) domestic liabilities in multi-regional banks.

C3.13 However, there is no single institutional model to be copied here since some countries have regulation and resolution authorities separated from the Central Bank. For example, in the US, the Federal Deposit Insurance Corporation regulates the safety and soundness of banks, whilst twelve regional Federal Reserve Banks act as operating arms of the Federal Reserve System. In Ireland, the Irish Central Bank has a wider role as it is responsible for supervising the conduct of banks, in addition to monitoring their financial health. In the UK, the Bank of England’s Prudential Regulation Authority performs that function through its Financial Conduct arm.

The Monetary Responsibilities of the Scottish Central Bank

C3.14 The Scottish Central Bank would act as banker to the Scottish Government, and hold deposits and provide liquidity support (subject to the asset and collateral requirements discussed below) for Scottish retail banks and operate a clearing system for these banks. This would replicate the existing structures for the UK (a real time gross settlement system alongside a net clearing system) but with advances in ‘fintech’ and the opportunity given by the establishment of a system from scratch it may be that there are more innovative options. In any event, all Scottish retail banks are currently, and are likely in future to be part of larger groups with access to the existing UK and EU clearing systems.

C3.15 Decisions as to the volume, timing and structure of Scottish Government debt would be made by the Scottish Treasury, but within the Debt & Asset Management Office (DAMO) (as proposed in Part B) which would oversee administration of issues and payments. The objective of the DAMO would be to ensure the efficient and low-cost provision of funds to the government, not to use government debt as an instrument of monetary policy. There could not be any separate Scottish analogue of ‘quantitative easing’, given Scotland’s small size relative to the existing sterling paper market.

C3.16 The money market activities of both Scottish Treasury and Scottish Central Bank would need to be integrated with whatever arrangements were made following negotiations for any division of overall UK debt. Scotland’s engagement with the pre-independence assets and liabilities in the Bank of England’s asset purchase facility would be a matter for discussion in negotiations over the overall UK debt position. Such negotiations would
consider the balance sheet of the UK Government as a whole, not necessarily confined to financial assets and liabilities. In any event, the position of the UK Government as largest holder of UK Government debt is highly relevant to these discussions. Whatever the outcome of such negotiation, the legal liability for payment and the operational liability for servicing UK debt issued before independence will lie with the rest of the UK as successor state as detailed in our first report.

C3.17 By retaining Sterling we accept interest rates in Scotland would be set, as now, by the Bank of England. The Scottish Government would begin independent life with no, or virtually no, debt of its own. But we recommend in Part B that it should commit to servicing a share of historic UK debt. As we noted in Part B, it is likely that there would initially be some premium on Scottish Government debt over UK interest rates, reflecting the relative illiquidity of the initial market in Scottish debt and the unfamiliarity of markets with Scottish Government paper. But consultation with rating agencies suggests that this premium would be less than 1%. However, with prudent fiscal management this premium could be reduced or even reversed. Denmark and Switzerland have the lowest borrowing rates in the world, despite their small size relative to the Eurozone (Table 3-1).

Table 3-1 – Long Term Government Interest Rates

<table>
<thead>
<tr>
<th>Long term rates (Government Bond Maturing in 10 Years)</th>
<th>2016 (%)</th>
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<tbody>
<tr>
<td>Denmark</td>
<td>0.321</td>
</tr>
<tr>
<td>Finland</td>
<td>0.365</td>
</tr>
<tr>
<td>France</td>
<td>0.468</td>
</tr>
<tr>
<td>Germany</td>
<td>0.090</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.688</td>
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<tr>
<td>Norway</td>
<td>1.332</td>
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<tr>
<td>Sweden</td>
<td>0.519</td>
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<tr>
<td>UK</td>
<td>1.305</td>
</tr>
<tr>
<td>USA</td>
<td>1.842</td>
</tr>
</tbody>
</table>


C3.18 There is, however, no reason why Scottish businesses and home owners should need to borrow on terms in any way different from their rest of UK counterparts: loans to them will not carry any extra risk. It is possible, as has happened in other jurisdictions including the US, that first class private sector borrowers in Scotland could from time to time borrow at more favourable rates than their own government.

C3.19 In the period between a referendum vote and independence, the new organisation will need to build up appropriate expertise to enable it to exercise the functions of the Scottish Central Bank after independence. Much of this recruitment will need to be undertaken
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internationally, but there will be many people with regulatory and Central Banking experience who will respond to the challenges and opportunities in establishing a new agency in a country with an especially strong heritage in financial services.

The Structure of Banking after Independence

C3.20 The significant banks operating in Scotland are banking groups whose main activities, assets and liabilities are located outside Scotland (with the possible exception of Clydesdale and Yorkshire Banking Group). It would not be right, or practical, for the Scottish-taxpayer to be asked to guarantee the overall liabilities of these banks.

C3.21 Current EU principles allow banks to trade in other member states through either branches or subsidiaries. Under EU passport rules, the primary responsibility for regulation of a business operating through branches lies with the home country (and in the event of failure claims must be made against the home country’s deposit protection scheme) while subsidiaries are regulated by their host country and their depositors are protected by the host country.

C3.22 EU rules require that deposits of up to €100,000 are protected – the current UK figure is therefore £85,000. A cap is desirable to protect the scheme against fraud but at any time there is likely to be a small but significant number of households with very large balances for bona fide reasons, e.g. because they are buying or selling a house. Since 2015, there have been special provisions enabling the scheme to provide compensation up to £1 million in such cases.

C3.23 Thus, when the two principal Icelandic banks failed in 2008 (although Iceland is not an EU member the EU principles applied), Kaupthing was a subsidiary of the Icelandic parent and Landsbanki a branch. UK depositors of Kaupthing were automatically protected by the UK Financial Services Compensation scheme but Landsbanki depositors had to look to the Icelandic scheme, which failed (since all its contributing members were effectively bust). In practice, the UK Government, through the Bank of England, arranged that all UK depositors in both banks were paid out in full (i.e. the relevant liabilities of Landsbanki were covered, although there was no obligation on the UK Government to do so, and the cap on protected deposits was not applied to either Kaupthing or Landsbanki retail depositors) and the UK has attempted, controversially and with limited success, to recover some of the resulting losses from the Icelandic Government.

C3.24 The costs of compensation are in principle recoverable from all firms in the same sector, so that losses to depositors in insolvent banks are met by solvent banks. In practice, however, the UK FSCS met its obligations (and the additional ones imposed by the UK Government) through a loan facility from the Bank of England in excess of £20 billion. In the case of Northern Rock, the bank was nationalised and the state-owned entity met claims against it.
in full; the FSCS was not involved. Such temporary state control may be the preferred route for a failed bank - see below.

C3.25 Banks operating in Scotland through Scottish subsidiaries (and hence primarily regulated by the Scottish Central Bank) would be required to ring-fence their retail banking operations, on the lines proposed for the UK by the Independent Commission on Banking and currently in process of implementation. After consultation, the Scottish Central Bank would introduce such rules on capital structure and asset quality on retail banks as are necessary to ensure that adequate collateral is available to match retail (i.e. household and small business) deposits in such banks. The objectives are to ensure that deposits are protected (if necessary by the provision of temporary liquidity against such collateral), and are protected in full (i.e. above as well as below the €100,000 limit), enabling the activities of failing banks to be continued or (more usually) transferred to another provider (if necessary with Scottish Central Bank or deposit guarantee), and to do so while involving minimal risk to the Scottish taxpayer or other Scottish banks. The Scottish Central Bank would be required to put in place a resolution regime similar to that which now exists for the UK to facilitate the orderly winding down of failed banks.

C3.26 Financial support from the Scottish Central Bank would be provided only to the ring-fenced retail entities operating in Scotland. If the requirements of ring-fencing are enforced and maintained, it is unlikely that these entities would encounter difficulties of either solvency or liquidity. If they did, and the parent were holding company were unwilling or unable to provide support. The SCB would provide such support as might be needed to ensure that cash would be available to meet the needs of retail and small business depositors.

C3.27 Given the requirement for ring fenced retail entities, the scale of the support that the SCB would provide would be manageable. The short-term support would be funded from the SCB balance sheet or, if the scale required it, from lending on commercial terms. The longer-term exposure of the SCB would be limited since the cash support provided to protect depositors would be offset by the value of the bank’s ring-fenced assets. In practice, it is likely that the potential availability of such support would make its actual provision unnecessary.

C3.28 Such financial support would not extend to holding companies of retail banks (even if based in Scotland, and a-fortiori not to financial holding companies not based in Scotland.) It is likely that the result would be that some companies would move their domicile to England in response, in expectation of broader support from the Bank of England. This is in any event logical, since regardless of the location of the registered offices of RBS and Lloyds Banking Group, a substantial part of the executive functions of these banks is already exercised in London. Indeed most, if not all, of the banks have already made clear in public statements that they would be headquartered in London for the purposes of regulation in the event of independence. During the independence referendum in 2014 the charge was
made that an independent Scotland could not afford to “bail-out” banks deemed too big to fail. Given all of the above, this charge is no longer relevant.

C3.29 Two issues arise for Scotland from these anticipated re-domiciles. One is whether there would be a significant loss of operational activities in the banking sector. Public statements from the CEO of RBS Group for example suggest this will not be the case. The other is the impact on tax revenues.

C3.30 Decisions by multinational corporations - including financial conglomerates - about where to locate operations are primarily determined by considerations of efficiency and cost rather than the location of their registered office. In 2015-6, total UK corporation tax revenue from the banking sector as a whole was £3.2 billion (about 7% of total UK corporation tax revenue). This figure includes revenue from foreign banks operating in the UK. This low figure is the result of historic losses (although action has been taken to limit this effect) and the complex corporate structures of UK financial institutions, which are substantially driven by tax considerations. In addition, the bank levy, an arbitrary tax on bank liabilities, raised £3.4 billion. While a Scottish Government could introduce a bank levy, an alternative possibility would be to ring-fence Scottish retail banking for corporation tax as well as regulatory purposes. We judge that it is probable that the revenue from this would exceed the £500-600 million (around 1% of prospective Scottish Government tax receipts) which would represent a pro rata share of total UK Government revenue from the banking sector.

C3.31 The policy approach of the Scottish Government should be to maximise continuity – of the rulebook and the approach to supervision – and hence to minimise uncertainty.

C3.32 There is a range of possible outcomes for the structure of the Scottish banking system that are likely to be satisfactory from a Scottish and the rest of the UK Government perspective, and from the perspective of the industry. We might naturally expect that some banks will modify their corporate structure to maximise their flexibility.

C3.33 In the longer-term there is a great opportunity for banking in Scotland. While the rulebook for banks in Scotland will be the European one – which may mean some divergence with the rulebook in the rest of the UK – the supervisory culture and institutional structures in Scotland will remain closely aligned with the arrangements in the rest of the UK. This means that Scotland will (and should seek to) become a natural bridge between the rest of the UK and the EU. The scale of the opportunity for financial services and jobs in Scotland is substantial.

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1 For example in a BBC interview on 16 August 2016
Scottish Financial Authority

C3.34 While the focus of political debate around the monetary framework for an independent Scotland has tended to be in the banking sector, the issues that arise are easily dealt with, as described above. Most of these relate to the operations of the Scottish Central Bank.

C3.35 The role of the Scottish Financial Authority will be to focus on other parts of the financial sector in Scotland, including those areas where Scotland has well-established, globally competitive expertise. This includes asset management in particular. The Scottish Financial Authority would be a separate institution to the Scottish Central Bank but it should be established as a wholly owned subsidiary.

C3.36 For any asset manager, it is a key requirement for long term success and viability that investors and clients have confidence in the level and quality of supervision and regulation. This prerequisite applies even more acutely for cross-border business and overseas clients and regulators will also expect appropriate levels of cooperation with the home country regulatory bodies and a credible body of law and regulation.

C3.37 In the context of an independent Scotland, it will therefore be important that all relevant stakeholders are given confidence in the newly established regulatory infrastructure. It would also be beneficial to have a sensibly planned transitional phase to ensure that there is no disruption to the delivery of services to investors and clients, and continued supervision of the activities of asset managers.

Policy Objectives

C3.38 A well-functioning savings market is important in three respects which should be reflected in policy:

- Scottish savers, individuals and institutions alike, will demand a system in which they can have full confidence. Regulation is a key element in building confidence. Credibility from day one will be essential because confidence is more easily lost than regained.

- Asset management, pensions and insurance are important parts of the Scottish economy, providing well-paid jobs and generating tax revenues. Most revenues earned by major firms are from investors and customers outside Scotland. Policy should aim to ensure that Scotland remains an attractive base for the underlying asset management activities. This requires credible regulation as an absolute prerequisite and policy should also aim to make the potential addressable market for Scottish managers as wide as possible. In this respect, the rest of the UK will be most important, and a regulatory regime maintaining reciprocal access should be a policy goal.

- It is important that Scotland has access to international capital. Government, businesses and households all depend on external capital to finance their activities. As a small,
open economy, it is in Scotland’s interests to maintain credible regulation as a means of encouraging providers of capital to do business with us on favourable terms.

Overarching Principles

C3.39 The government, business and the public should have clarity on the objectives of the financial regulatory system. Using the International Organization of Securities Commission’s (IOSCO) principles, these objectives could be described as:

- Protecting Investors;
- Ensuring fair, efficient and transparent markets; and
- Reducing systemic risk.

C3.40 As an example, the Central Bank of Ireland’s mission statement is “Safeguarding Stability, Protecting Consumers”. While the UK FCA has an overall objective of ensuring that relevant markets function well, supported by three operational objectives covering consumer protection, integrity of markets and promotion of effective competition.

C3.41 A close proxy for these principles would be a requirement for an independent Scottish financial regulator, even if organisational structures differed. The financial regulator should be operationally independent from Government but with appropriate political accountability for its actions and successful delivery of its objectives. It is particularly difficult to be specific about the future of regulation so long as the future relationship between the UK and EU (with or without Scotland) remains as vague as it does today. This uncertainty is particularly great in relation to financial services. Brexit will be damaging to the Scottish financial services industry and regulation will need to be crafted to minimise that damage.

Conduct and/or Prudential and Scope of Regulation

C3.42 An incoming independent Scottish administration would need to decide whether to operate a unitary regulatory model, such as pertains in Ireland, or whether to adopt a twin peaks model, splitting prudential and conduct regulation as is the case in the UK. The greater simplicity of the former approach would make it an attractive choice given Scotland’s starting position.

C3.43 The FCA’s and PRA’s models and responsibilities are the obvious point of comparison for the new Scottish system. Differences are possible, of course, but should be clearly explained with assurance that quality of supervision has not diminished unduly.

Core Activities

C3.44 The new regulator would perform four core activities:

i. Policy making;
ii. Authorisation and supervision of firms and individuals;
iii. Enforcement;
iv. Internal operations.

C3.45 The first of these also requires specialist knowledge in the wider civil service. Ministers would need advice on the appropriate policy choices at a high level. Civil servants would need to be qualified in drafting suitable legislation to underpin the policies and rule books. Effective supervision also requires a considerable cohort of highly trained staff to oversee the complex operations of financial institutions.

C3.46 Similarly, enforcement requires a high degree of expertise and resource within the Scottish police and courts system to address complex financial crime such as money laundering.

C3.47 In addition, there would be a need to establish a relevant financial services compensation scheme providing a fund of last resort for consumers in the event that a financial services firm is unable to pay claims made against it. The UK FSCS is funded by the financial services industry and the levy is paid annually split across five categories: deposits, life and pensions, investments, general insurance, and home finance. With a smaller population of firms in Scotland and relatively few larger firms, the funding of such a scheme will need to be carefully managed so that it is not unduly burdensome on certain firms within the sector. Again, the current UK levy is an obvious point of comparison.

C3.48 A complaints and redress mechanism similar to the Financial Ombudsman Service - an independent body created under statute to provide an impartial complaint handling service for consumers – is also the international norm.

Practical Considerations

Resourcing

C3.49 The incoming administration will need to assess resourcing of the financial regulator prior to independence. Taking human resourcing first, looking at precedents, the Central Bank of Ireland stated in its 2015 annual report that it had around 1500 staff with a split of 300 in the central bank, 700 in regulation and 500 in operations. Taking a smaller operational example, Malta has 330 in its Central Bank and 280 in its financial regulator.

C3.50 Depending on the scope of activities and level of support from existing regulatory infrastructure in the UK, Scotland could be looking at a regulator potentially of 700 in number, of which at least 200 would need to be skilled and qualified professionals.

C3.51 In terms of operating costs, if we take the FCA as an example, its operating budget for 2016 was in the region of £520 million. This is funded by the fees levied on regulated firms, less any rebate for penalties retained from enforcement actions. Regulated firms in Scotland
will therefore be interested in understanding the impact and costs of supporting a new regulator in that jurisdiction, particularly given that many will choose to remain regulated by the FCA in the rest of the UK. Care should be taken to make Scotland cost-competitive in this regard.

**Legislative Framework**

C3.52 The practicalities of enacting a financial services legislative framework across all financial services activities will need to be considered. The care needed is heightened by the likely desire to retain equivalence with EU regulation in order to retain access to the EU single market in financial services. The complicating factor is that the apparent on-going debate within the UK Government on whether UK regulation should diverge from EU regulation following Brexit. It will be in the interest of the UK and Scottish financial services sectors to minimise divergence between UK and EU regulation. The rest of the UK market is important to most Scottish asset managers, consequently the objective of maximising access to both rest of UK and EU markets should be central to Scottish Government policy.

**International Dimension**

C3.53 The UK FCA has in place a series of memoranda of understanding with regulators globally which facilitates the exchange of information and cooperation of regulators regarding firms and activities which affect both countries. Scotland would need to ensure that similar arrangements are replicated for the Scottish regulator, and this will be important for the on-going facilitation of cross border business from Scotland. Likewise, it is important that an independent Scotland benefits from similar trade agreements and double tax treaties as are currently in force for the UK to support the sale of financial products and services from Scotland.

**Systems and Processes**

C3.54 Regulators are data driven. This requires a significant investment in technology to ensure that data from regulated firms can be received, stored and analysed. An appropriate transition from the UK FCA would also need to be coordinated to ensure a seamless transfer of records across regulators.

**Transitioning to the New Regime**

C3.55 Given the scale of the undertaking, as a general principle the policy should be to grandfather as much as possible from the rest of the UK arrangements, and inherit as much as possible too, including:

- Automatic authorisation of Scottish based firms: Asset management firms with a Scottish domicile or operations which are currently regulated by FCA should be grandfathered and automatically regulated by the Scottish regulator. There should be a simple transition process and no new or replacement application process. This
grandfathering process should cover both the firm and also all individuals (Senior Managers under the new FCA regime expected in 2018).

- Retain authorisation and regulation by the FCA: Given the scale of the activities performed in the rest of the UK by Scottish based asset managers, it would be helpful to ensure they can continue to be directly regulated by the FCA for the rest of the UK client base, so that there is no change to this regulatory relationship, as would happen if rest of UK operations were subsidiaries. In that way, authorisation by a Scottish based regulator becomes an additional regulator, rather than a replacement regulator. Any increased cost to doing business in Scotland would then be minimised in order to ensure the continuity of regulatory oversight. Over time, this position could be reassessed.

- The arrangements between UK FCA and Scotland should aim for a reciprocal arrangement such that UK FCA regulated entities can delegate activities to their affiliated entities in Scotland. The benefit of this regulatory reciprocity to the Scottish economy is twofold. First it reduces the extent to which asset management activities may migrate to London in order to maintain a regulatory relationship with the FCA. Secondly, there is less disruption to the Scottish savings market, allowing the highly integrated UK market to remain in force, increasing consumer choice and encouraging competition.

- Inherit existing infrastructure: Where possible the Scottish regulator should use the existing systems and processes of the FCA so that there is as seamless as possible an interaction with the new Scottish regulator. This may also involve the secondment or use of FCA staff resources during the early stages of establishing a separate Scottish regulator or, more radically, agency work by the FCA for a period. The capacity of the FCA to accommodate this would of course be vital. The separation settlement could acknowledge historical Scottish investment in the UK regulator to help this happen.

- Adopt existing rules and legislation: so that there is no operational impact on day one, existing UK rules would need to be applied. In other words, UK legislation would be assumed into Scottish law and the FCA and PRA regulatory rule books adopted by the new Scottish regulator. On day one, given the EU Withdrawal Bill process, the rest of the UK, Scottish and EU regulation should be identical. However, there is the complication that over time, UK rules may start to diverge from EU standards and therefore Scotland needs to have capacity and capability to legislate over the medium term to adapt accordingly, to the interests of the Scottish financial services sector.

- Financial Services Compensation Scheme: a Scottish scheme similar to the existing UK scheme should be established, providing full coverage for insurance claims and coverage up to £85,000 for other financial services claims, including those of bank depositors, with a seamless transition so that there is no gap in coverage.
Financial product regulation: this will be a particularly important area for firms where products domiciled in Scotland which are held by or sold to the rest of the UK customers become cross border products. Cross-border sale of products and services forms a significant share of most Scottish based firms’ business. For some financial services providers, the potential uncertainty which this creates for investors and policyholders in these cross-border funds may create a commercial imperative to establish mirror products in the rest of the UK and transition the rest of the UK clients into these structures. It would be helpful if legal and tax mechanisms were developed and implemented prior to independence to facilitate the re-domiciling of such products in a cost-effective way for investors. This would allow firms to adapt their product line up to match their shareholder/investor base as appropriate. However, by providing clarity about currency and financial regulation, such uncertainty would be minimised.

C3.56 Returning to the position of Scottish-based managers and pre-existing funds registered in EU27 states, one of the essential requirements is that managers or funds in the EU27 jurisdictions are able to delegate portfolio management back to an asset manager based in Scotland. In any transition to an independent Scotland, an important task will be to ensure that Scotland is recognised as a third country to which portfolio management can be delegated. This relates directly to the perceived competence of the new Scottish regulator and the credibility of the regulatory framework.

C3.57 Should an independent Scotland meet these criteria, it could be an attractive venue for asset managers, including some not currently based here.
C4 KEY QUESTIONS & ANSWERS

Will there be a Formal Monetary Union?

C4.1 No, a formal monetary union will not be required. However, the Scottish Government expects that there will be a close and cooperative relationship between the new Scottish Central Bank and the Bank of England. The Scottish Central Bank and Scottish Financial Authority will assume in Scotland the regulatory functions presently exercised in the UK by the Bank of England’s Prudential Regulation Authority and the Financial Conduct Authority.

What Notes and Coin will be used in an Independent Scotland?

C4.2 As now, currency in circulation in Scotland will continue to be a mixture of Bank of England notes and notes issued by Scottish banks. Scottish banks must currently support their note issue by making equivalent deposits with the Bank of England. On independence, this obligation will transfer from the Bank of England to the Scottish Central Bank. Otherwise, currency arrangements will continue as now. Depending on future arrangements with the rest of the UK, the Scottish Central Bank may choose to operate a payment and clearing system based in Scotland.

What will Happen to Bank Accounts after independence?

C4.3 Nothing. Bank accounts are private contracts, payable in sterling, between the account holder and the bank. Depending on the bank, this contract may be with an English or Scottish registered company and enforceable under either English or Scottish law. Neither the UK Government nor the Scottish Government is a party to that contract. Banking arrangements will be therefore be unchanged by independence and account holders will be able to make deposits, withdrawals and payments exactly as now.

Will it be possible to obtain Bank of England Notes from Banks in Scotland after Independence?

C4.4 Yes. At present bank branches will (if you have sufficient credit) give you Bank of England notes, or Scottish bank notes, or Euros, or US Dollars, or (with appropriate notice) any other currency you ask for. Mostly, this currency has been deposited with the bank by other customers but, if the bank does not have sufficient of the relevant currency, it will buy the required currency from another institution which does. This will continue to be the position after independence. In practice, all Scottish banks have substantial operations outside Scotland and already conduct operations in multiple currencies.
Will Bank Deposits be Safe?

C4.5 Yes. The Scottish Government will introduce a Scottish Financial Services Compensation Scheme which will provide deposit protection similar to that currently offered in the UK and all EU member states, as part of their respective banking unions. In addition, the Scottish Government will take over and reinforce the UK banking legislation which will become effective in 2019. This legislation requires banks to ‘ring-fence’ their retail operations, ensuring that these retail activities are separately capitalised, supported by a distinct pool of assets, and are operationally and in governance terms distinct from other activities of the holding company which owns the bank. Put simply, their purpose is to separate traditional banking from the wholesale and trading activities of the financial conglomerates which most ‘banks’ have become.

C4.6 The Scottish Central Bank will have a primary objective of restoring Scotland’s reputation for prudent banking which services the needs of Scottish households, businesses and the Scottish economy, in a competitive market for banking services.

Who will be Lender of Last Resort?

C4.7 The significant banks operating in Scotland are banking groups whose main activities, assets and liabilities are located outside Scotland (with the possible exception of Clydesdale and Yorkshire Banking Group). If either the Scottish banking operation of a retail bank or the holding company which is the ultimate owner of a Scottish bank is unable to meet its obligations, the Scottish Central Bank will take over the ring-fenced retail operations of that institution in Scotland, but not for those parts outside.

C4.8 In such circumstances, normally the Central Bank will sell the assets and liabilities of the bank or the bank itself to other financial institutions (as the Federal Deposit Insurance Corporation does in the United States and as the UK Government did with the operations of Alliance and Leicester, Bradford and Bingley and Northern Rock). It may be necessary for the Scottish Central Bank, with the support of the Scottish Government, to provide temporary guarantees or liquidity support to facilitate such a transfer of activities. But with the introduction of ring-fencing and proper capitalisation and supervision of retail activities such support should not involve any significant cost to Scottish taxpayers.

C4.9 Neither the Scottish Government nor the Scottish Central Bank will bail out failed or failing financial institutions, although they will consider cooperating in international rescue or resolution operations in the interests of global financial stability. If this principle leads ‘too big to fail’ financial institutions to register their place of business outside Scotland, then Scottish taxpayers will be protected from the costs of such support operations and the consequences of irresponsible banking. Such re-domiciling of place of registration is unlikely to have any substantial effect on the operational locations of the banks in question.
The objective of the Scottish Government will be to restore Scotland’s reputation for prudent banking and meeting the needs of the Scottish economy.

**Will Unit Trusts (OEICs), Investment Trusts, or Other Shares be Affected by Independence?**

C4.10 No. These investments entitle those that hold them to a share of the assets and earnings of companies, some of which are inside Scotland and some outside. Their value and denomination will not be affected in any way by Scottish independence. Shares and investment trusts are listed on the London Stock Exchange (or some other regulated market) and, if they are London listed, their prices are quoted in sterling. This will continue to be the case after independence (and would continue to be the case even if at some later date Scotland adopted another currency).

C4.11 The Scottish Government will, at independence, adopt in full the existing rulebook of the UK Financial Conduct Authority, including in particular its regulations regarding protection of client money, conduct of business, and ‘treating customers fairly’. Savers and investors, whether they are Scottish residents or customers of Scottish businesses, will continue to enjoy exactly the same regulatory protections as now.

**What will Happen to Insurance Policies?**

C4.12 Nothing. As with bank accounts, insurance contracts are private contracts with the company concerned and are unaffected by the constitutional change. The Scottish Government will ensure that policyholder protection similar to that currently applicable in the UK will be available under the Scottish Financial Services Compensation Scheme. The Scottish Central Bank will implement a regulatory regime for insurance in Scotland equivalent to that operated by the Bank of England’s Prudential Regulatory Authority.

**What will Happen to Occupational Pensions?**

C4.13 This is governed by the trust deed established by employers. Entitlement will therefore be unaffected by independence or where people choose to live. The Scottish Government intends to negotiate arrangements for the joint regulation of occupational pensions with the rest of the UK, since so many schemes are UK wide, but if necessary will establish a Scottish pension regulator and pension protection scheme.

**Will an Independent Scotland Adopt the Euro?**

C4.14 Scotland would retain sterling. If Scotland became an EU member in the future, it would be ready to accept that the euro is the official currency of the European Union, albeit that it is the actual currency of only 19 of the 27 member states. This acknowledgment does not
oblige Scotland to join the euro, either at independence or in the future. Denmark and Sweden are not members of the Eurozone and have no plans to join.

C4.15 Denmark obtained derogation at the time of the Maastricht Treaty and Sweden has stated that it does not intend to comply with the relevant criteria of that Treaty for membership of the Eurozone, a position which the EU has accepted. Scotland would join the euro only if and when such a decision is in the best interests of both Scotland and the EU, and the relevant criteria of the Maastricht Treaty were met.

Will there be Capital or Exchange Controls in an Independent Scotland?

C4.16 No. In today’s world of electronic transfers and global capital and currency markets, it is very difficult to make effective controls on movement of capital or to stop residents from exchanging currencies. Such restrictions would be inconsistent with Scotland’s future as a small open economy.

Will an Independent Scotland Adopt a Distinct Scottish Currency?

C4.17 Not in the short to medium term. The Scottish Government should commit to retaining sterling for an extended transition period. In due course, the Scottish Government should consider, on the advice of the Scottish Central Bank, whether this arrangement continues to be in the best interests of Scottish business and Scottish residents against a series of tests set out in advance of independence.

What Would Happen to Savings if Scotland did Adopt a Scottish Currency?

C4.18 Nothing. The majority of financial arrangements are private contracts between individuals, households and businesses, and financial institutions. These contracts are made in sterling and would continue to be in sterling unless the parties agreed to change their terms. For example, you could (but need not) agree with your bank to convert your mortgage or bank account from pounds sterling to any new Scottish currency. The Scottish Government could in principle pass legislation changing the terms of existing private contracts but has no intention of doing so and would gain no advantage by doing so: indeed, such legislation would be open to challenge under the European Convention on Human Rights and the provisions for the protection of property rights.

C4.19 If Scotland did at some time in the future adopt another currency, Scottish businesses and households would be free to conduct their business in sterling, the Scottish currency, or another currency – as they do now. It is likely that most businesses and many households would choose to maintain accounts in sterling as well as the Scottish currency. Euros circulate widely in both Denmark and Sweden and as more and more transactions become electronic this flexibility is likely to increase – and become less important. As many Scots travelling abroad will have experienced, national differences in currencies have much less
practical significance than they once did with the rise of plastic cards and electronic transfers.

Would Scotland need permission from the Bank of England to use Sterling?

C4.20 No. At the time of the 2014 referendum, the Scottish Government assumed more cooperation in financial and monetary arrangements than the UK Government was willing to extend. The Scottish Government’s current plans therefore assume little or no cooperation. In practice, once the Scottish people had voted for independence, there would be a mutual interest between Scotland and the rest of the UK in securing a smooth transition. Regulators on both sides of the border and internationally could be expected to do everything in their power to promote stability and continuity.2

2 Such continuity plans were in place at the time of the 2014 Scottish independence referendum, as referenced in the Bank of England’s Financial Policy Committee meeting minutes from 24th September 2014.
**C5 PART C: SUMMARY OF MAIN RECOMMENDATIONS**

C5.1 As with Parts A and B we make a number of recommendations and encourage these to be considered immediately in terms both of what can be achieved now alongside what might take longer term preparation, broader co-operation or greater policy responsibility and control.

44. **Currency Recommendation – Sterling Retention:** The Commission recommends that the currency of an independent Scotland should retain the pound sterling for an extended transition period.

45. **Currency future options: governance and tests:** In order to secure maximum long-term certainty, we recommend that the governance and rules should be set in advance. We recommend 6 tests detailed in the report for a future decision on currency to be based upon:
   
   i) Fiscal sustainability
   
   ii) Central bank credibility and stability of debt issuance
   
   iii) Financial requirements of Scottish residents and businesses
   
   iv) Sufficiency of foreign exchange and financial reserves
   
   v) Fit to trade and investment patterns
   
   vi) Correlation of economic and trade cycle

46. **Scottish Central Bank: should be established.** This should be created to act as banker to the Scottish Government, holding deposits and providing liquidity support (subject to asset and collateral requirements) for Scottish retail banks and provide a clearing system for these banks. Assuming the functions in Scotland of the FCA and PRA through its SFA subsidiary.

47. **Scottish Financial Authority:** as an independent wholly owned subsidiary of the Scottish Central Bank. Adopting the responsibilities of the UK FCA and PRA it would also take the lead on other (non-banking) parts of the financial sector in Scotland.

48. **Scottish Financial Services Compensation Scheme:** should be established by the SCB mirroring the UK FSCS scheme.

49. **Bank regulation:** banks regulated for their activities in Scotland by the SCB/SFA would be required to ring-fence their retail banking operations. A resolution regime would be established mirroring the UK approach for the orderly winding down of failed banks.
The transition arrangements would ‘grandfather’ as much as possible from the UK arrangements.

50. **Lender of Last Resort**: the SCB will act as lender of last resort to individual banks with a liquidity rather than solvency problem and provide emergency liquidity assistance to the banking system where there is a systemic need. After consultation, the SCB would introduce rules on capital structure and asset quality on retail banks to ensure that adequate collateral is available to match retail deposits in such banks. Financial support should only be provided to the ring-fenced retail entities operating in Scotland. It should not extend to the holding companies of retail banks whether operating in Scotland or elsewhere.