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Explainer: why independence might force finance giants to leave Scotland

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Sunset for Edinburgh finance sector? Tim Caynes, CC BY-SA

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With the likes of RBS, Lloyds/Bank of Scotland and Standard Life all raising concerns about the prospects of Scottish independence in recent days, various commentators have been pointing to the risks that these institutions will relocate south in the event of a "yes".

Certainly it is safer for a financial institution to deal in a currency that is tested. Whereas the Bank of England has issued currency and formulated monetary policy for some time, a new untested central bank is a great question mark. A currency that is supported by a relatively large economy is also more reliable than a currency supported by a smaller one.

For these reasons, the only solution that would make the big financial institutions indifferent over whether to base themselves in Scotland or England is a currency union. As has been made clear elsewhere, this would require fiscal coordination to avoid running into the kinds of problems we have seen with Greece in the Eurozone. It also requires that Scotland and the rest of the UK agree to take common responsibility for bailouts in times of trouble.

Scotland's other Sterling options

If the UK did not agree a currency union, there are two other options that an independent Scotland could adopt if it wanted to keep sterling. The first is to use it unilaterally, which First Minister Alex Salmond has been hinting is his preferred "plan B". The second, known as a currency board, is to keep the current system of private banks issuing Scottish pounds fully backed by sterling. Just like with a currency union, both options would deprive an independent Scotland of its own monetary policy and would force her to adopt a fiscal policy compatible with the new UK.

RBS boss Ross McEwan is among those concerned about a yes vote. Andrew Milligan/PA Wire

From the Scottish financial institutions' perspective, the currency board option would be risky since Scotland could suddenly decide at some point in future that it would no longer honour the agreement to exchange Scottish pounds for sterling. There is also a high degree of uncertainty around the unilateral adoption option. This is because any economy using another country's currency must be strongly related to the country issuing the money.

In the case of Macao's pataca, the currency board is based on the Hong Kong dollar due to the fact that Hong Kong is the main source of Macao's income. Panama's main revenue source is the US dollar fees for the Canal, which is why the country uses the US$ as its currency. Kosovo uses the Euro for similar reasons.

All these economies' business cycles are compatible with the countries whose currencies they use. This was not the case when Argentina began using the US dollar as its backing currency in the 1990s.

Argentina's main trading partner was Brazil, which led to tragic consequences when the Brazilian real ran into problems and fell heavily in value against the US dollar. This meant that Argentina's exports were suddenly very expensive in Brazil, which meant people stopped buying them, causing heavy damage to the Argentinian economy.

A peso for your thoughts?

How does this apply to Scotland? Its main trading partner would be the new UK, so it should have enough sterling to use the currency. Compatibility might start to be an issue, though, since a small economy with oil as one of its main assets will be pulled in very different directions from a big one that does not have much oil assets. This compatibility issue is why oil-rich Norway has never joined the EU.

The financial institutions are aware of this fact. And as we saw with Ireland and Iceland, a small economy can hardly support a large finance sector during a financial crisis. This is why Danny Alexander and others have said that an independent Scotland would find it difficult to persuade its big financial institutions to stay if it chose to use sterling without a currency union.

But regardless of what happens over the currency, an even bigger issue for Scotland's financial institutions is the European Union. Any financial institution registered in a European member state gets what is called a European passport. This allows them to operate without restrictions in all other member states. These activities are overseen by their home state supervisor. In the UK, including for Scottish institutions, the supervisor for banks is the Bank of England and for insurance it is the Prudential Regulation Authority.

If Scotland votes for independence, all Scottish financial institutions, no matter what currency is going to be used, would need to switch their allegiance to Scotland. After a transitional period they would be overseen by newly created supervisors within a new financial framework.

The framework would have to be compatible with EU law, so the regulations would be similar to the current ones. But the exact practice of these institutions would only be revealed through time. This would create much uncertainty, which any financial institution always tries to avoid.

The easiest solution for them would be to move headquarters to the new UK. This would ensure that their organisational structures would stay intact and they would be overseen by known supervisors and not by new untested ones. For a country like Scotland with a strong financial sector in Edinburgh, this is the reality if the referendum result is "yes".

Scotland, scottish independence **currency union**