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A Strategic Alliance Between the Public and Private Sectors: The Case of the Financial Services Strategy for Scotland

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Abstract

This paper begins by identifying some of the key themes in the literature relating to the growth of business services, and specifically financial services, in the UK and beyond. These findings then provide a basis for an examination of the specific role of financial services within the Scottish economy. Potential opportunities for, and threats to, growth in this sector are identified, and the implications of these for the future role of financial services within the Scottish economy are considered.

The later sections of this paper discuss the newly formed strategic alliance between private sector financial services firms and the public sector in the form of the Scottish Executive, which is designed to ensure the future growth of the Scottish financial services sector. The key elements of this strategy are discussed, and a number of questions raised regarding its probable success or failure.

Introduction

Over the course of the last thirty years, major structural changes have taken place within the UK economy with a consequent shift of economic activity away from manufacturing industry and towards services. During this time, the nature of service sector activity has become more diverse and the nature of service provision itself has changed, moving on from being simply an adjunct to manufacturing industry to a source of economic growth and trade in its own right (Beyers, 1990; Coffey and Polese, 1987; Daniels, 1982 and 1983; Illeris, 1989; Ochel and Wegner, 1987). This in turn has generated an increased interest in service activity within the literature.

One particular group of services that has attracted significant attention are those that fall within the “advanced producer services” group. Advanced producer services can be defined as follows:

> *“those services which are characterised as providing an intermediate input into the client firm’s production process and which are either knowledge (information) intensive or human capital intensive in nature.” (Daniels and Moulaert, 1991).*

Banking, insurance, other financial services, accountancy, management consultancy and other business services are generally included in this category, while other business to business services, such as cleaning and catering, which are less strategic in nature may fall within the wider “producer services” category (Daniels, 1983; Marshall 1983; Noyelle, 1983; Wood, 1996). The strategic nature of advanced producer services is of some importance within the context of recent debates regarding the relative value of in-house provision versus out-sourcing of business related services. In practice, however, relatively few organisations outside of the financial services sector supply financial services in house. Consequently the financial services sector itself can be identified as being strategic in nature via its role of providing corporate finance.

Within the literature, a series of papers have examined specific aspects of the delivery of these services, including the impact of Foreign Direct Investment on regions (Bagchi-Sen, 1997; O‘hUllachain, 1996; Ochel, 2002; Stare, 2001; Tokatli and Erkip, 1998); working practices and corporate organisation (Beyers and Lindahl, 1999; Goe, 1996; Moulaert, Todtling and Schamp, 1995; Phillips, MacPherson and

Lentnek, 1998; Wood, 1996a and 1996b); and customer-corporate relations (Beyers, 2003; Gadrey and Gallouj, 1998; McNaughton, 1999; O'Farrell and Moffat, 1995). Studies of individual industries within the advanced producer services group are, however, relatively rare within this body of literature (Coe, 2000; Daniels, 1986; Gentle and Marshall, 1992; Leyshon, Daniels and Thrift, 1987; Marshall and Bachtler, 1984).

The principal exception to this gap in the literature as far as both financial services and Scotland are concerned is Bachtler and Raines (1997). They note that the financial services sector had undergone rapid growth in both employment and output in the preceding decade, while simultaneously undergoing major organisational change in terms of automation, deregulation and increased market segmentation. These processes in turn allowed financial services companies to become more flexible in terms of location as "back office" functions no longer needed to be located close to customers, but could be moved to lower cost locations. By 1993 Scotland had the third largest financial services sector of the UK planning regions, accounting for 10.8% of total Scottish employment and 8.1% of all financial services employment in the UK. As will be shown below, the financial services sector is equally significant to the Scottish economy a decade later.

At least part of the impetus for the growth of the financial services sector during this period can be attributed to the regulatory changes that took place in relation to these services in the mid-1980's to early 1990's. Specifically, the 1986 Financial Services Act and the 1986 Building Societies Act significantly changed the nature of the financial services environment via a series of de-regulatory measures designed to promote and enhance competitiveness within this sector. These changes allowed financial services institutions much more flexibility in their operations and enabled many of them to pursue an extended growth phase. For example, building societies were now permitted to sell a much wider range of products than had previously been the case, which enabled them to compete with other financial institutions on a more even footing. Many companies either grew endogenously, for example the Nationwide building society, or exogenously by taking over smaller less competitive firms, for example the Abbey National takeover of National and Provincial building society. This resulted in substantive restructuring of the financial services sector across the UK, including Scotland.

Returning to Bachtler and Raines (1997) a further point to note is that although they found that Scotland had, like other regions, benefited from the decentralisation of back office functions from London and the South East, Scotland also had the advantage of the presence of a number of head offices of financial services companies. This provided an additional source of growth for this sector as locally based firms were found to be expanding significantly during the period of study. Consequently by 1997 financial services companies were already viewed as being an asset to the Scottish economy, although there were no specific policies being targeted towards them at that time.

Before moving on to look at recent policy developments in this area, we begin our analysis with an overview of the current role of financial services within the Scottish economy.

Overview of the Role of Financial Services within the Scottish Economy

In the first quarter of 2005, Scotland's Gross Domestic Product (GDP) rose by 2% year on year, with most of this growth being fuelled by the construction and service sectors, which grew at a rate of 3.2% and 2.6% respectively (Source: www.scotland.gov.uk). A more disaggregated analysis of the changes in the service sector reveals that, using 2001 as the baseline for analysis, financial services had experienced the fastest growth of all the Scottish service sub sectors in terms of gross value added with a rise of 23% – see Table 1. It should be noted, however, that the use of the 2001 baseline may slightly exaggerate the growth of the sector in that it had suffered, along with most of the Scottish economy, a downturn in fortunes in 2000-01. Consequently, the level of activity in the industry was probably below trend at this point.

Table 1 Gross Value Added chained volume measures at basic prices: service industries (2001=100)

	Transport, communications & storage	**Financial services**	**Real estate & business services**	**Public services**	**Other services**	**Total services**
2001	100	100	100	100	100	100
2002	103.6	103.0	107.6	102.9	108.6	104.0
2003	104.5	107.8	111.8	106.2	114.7	106.6
2004	105.9	117.4	114.8	109.4	113.8	108.7
2005Q1	109.0	123.0	117.9	111.1	116.0	111.2

(Source: www.scotland.gov.uk/Publications/2005)

This reinforces the importance of the financial services sector to Scotland's economy in terms of wealth generation, a role that is acknowledged by both the Scottish Executive and Scottish Financial Enterprise, an industry body which was established in 1986 to provide a forum for the discussion of key issues affecting the financial services sector.

Specifically, while London remains the dominant financial services centre within the UK, Edinburgh is currently the UK's second major fund management centre, with a majority share of the £300 billion of the funds currently being managed within Scotland (Source: www.dti.gov.uk/sectors_financial.html). Indeed, taking the Edinburgh and Glasgow financial services clusters in combination, the central belt of Scotland comprises the UK's second biggest overall financial services sector, while also being among the top 10 European centres for banking, insurance, pensions and investment management (Source: www.hm-treasury.gov.uk). In total, 108,100 people were directly employed in financial services in Scotland in 2003, compared to only 86,100 in 1999 which demonstrates the scale of recent job creation in this sector (Scottish Economic Report, April 2004). A further 90,000 people are also estimated to be employed in related industries. In addition, the total output of the Scottish financial services sector has grown by around 36.5% over the period 2000 to 2004 (Source: www.hm-treasury.gov.uk). In the banking sector alone, the Scottish banks currently have assets in the order of £360 billion and are responsible for an estimated

40% of UK corporate structured finance. This represents a significant degree of activity in UK, European and global terms.

According to the April 2005 Scottish Economic Report (Source: www.scotland.gov.uk), between 1998 and 2003 the growth rate of the financial services sector was significantly faster than the growth rate in total Scottish GDP. In addition to the rise in gross value added documented in Table 1 above, the financial services sector experienced a rate of employment growth greater than its overall share of employment, that is a 10% increase in employment compared to its then 6% share of the total Scottish labour market. The latter figure is indicative of the fact that the total numbers employed in financial services in Scotland have fluctuated in recent years, but the accelerating growth rate in employment can be seen as a more positive indicator of the health of this sector. This is accounted for by an increase in the number of both full-time and part-time jobs, although it is noticeable that the percentage of the total financial services workforce accounted for by part-time staff has risen by 1% to just below 19%. At least some of this increase may be attributable to a rise in the number of call centre jobs, many of which are part time in nature. A comparison of the growth rates contained in the report also reveals that the Scottish financial services sector has grown at a faster average annual rate than its UK counterpart, that is at an average rate of 7% compared to a UK rate of 2.9% between 1999 and 2003.

It is apparent from the annual figures given in Table 2 that the Scottish financial services sector experienced a faster rate of growth than the UK financial services sector as a whole in every year except 2001. In particular, the figures for 2002 indicate that the Scottish sector managed to avoid the “mini-recession” that occurred in the UK industry as the result of global economic uncertainty, and in particular a downturn in activity, combined with heavy losses, in the London insurance market.

Table 2 Financial Services Growth: Scotland and UK 1999-2003 (%)

Year	**1999**	**2000**	**2001**	**2002**	**2003**
Region					
Scotland	12.0	11.5	5.1	2.4	4.1
UK	3.8	5.0	5.2	-1.2	2.2

(Source: adapted from Scottish Economic Report, April 2005)

With respect to the figure for 2001, a series of mergers took place during 2000 and 2001 which had a disproportionate effect on the Scottish financial services sector. This may also in part explain the lower growth rates in the two subsequent years as the full effects of these activities fed through the industry. These included the mergers of Royal Bank of Scotland with National Westminster; the Bank of Scotland and Halifax; and Scottish Widows and Lloyds/TSB. The subsequent organisational restructuring which has taken place as a result of these changes has significantly altered the face of the Scottish financial services sector. Over-lapping branch networks have been cut, and the introduction of new technology, for example internet banking, has also reduced the number of staff employed. At the same time, the restructuring of the sector during this period also saw financial services jobs beginning to be relocated overseas, for example to India, as a cost cutting measure, although this did not always prove to be popular with the institutions’ clientele. Even firms that were not themselves directly affected by these mergers and acquisitions were forced to look more closely at their businesses in an attempt to reduce their costs in order to become more competitive and/or to avoid becoming the next takeover target. There is little doubt, however, that Scotland has also benefited to some degree from these, and other, changes in the sector. The corporate headquarters of the combined Halifax and Bank of Scotland group (HBOS) is located in Edinburgh where the Royal Bank of Scotland group also has its global headquarters. On a smaller scale, the Lloyds TSB/Scottish Widows merger resulted in more of the combined groups investment management work being located in Scotland. Moreover, the initial growth in call centre activity in Scotland was faster than for the rest of the UK, due to both the availability of staff and incentives in the form of, for example, relocation grants from central government. A later reversal of this position was perhaps inevitable, but to date it would appear that Scotland has experienced net gains in this area overall.

Subsequent anecdotal evidence suggests that this restructuring of the financial services sector is likely to continue for some time to come. In March 2004, for example, Standard Life announced 1,000 jobs losses in an attempt to become more efficient prior to its proposed demutualisation and stock market floatation. In addition, more and more companies hit the headlines in terms of the (proposed) off-shoring of call centre jobs from Scotland to other countries, most notably, Abbey and LloydsTSB within the banking industry, and Aviva and Prudential in the insurance industry. Despite this, however, the financial services sector remains both as a key part of the Scottish economy and a key component of the Scottish Executive's economic development strategy, alongside tourism and cultural industries.

The perceived need for targeted strategic help for the financial services sector may be at least partly attributable to the recent spate of company failures which have resulted in corresponding job losses. For example, between 2000 and 2003, 34% of companies operating in this sector had closed down, while in contrast only 17% has increased their employment levels over this period. Small financial services companies, defined as those with less than ten employees, were most likely to close (36%) while medium sized companies, with between 10 and 49 employees were least likely to do so (21%). Larger companies, those with 50-249 or over 250 employees were most likely to have increased their employment levels, 37% of firms in this category in each case. Conversely, only 16% of small businesses in the sector were likely to have expanded. (Source: Scottish Economic Report, April 2005) With respect to the large number of small firm closures, two possible causes suggest themselves. Firstly, it has been well documented throughout the literature that small companies and new start-ups in all sectors are more prone to bankruptcy than larger companies. Consequently this type of distribution of company closures might be expected as being typical of wider scale small firm behaviour. Secondly, it may be the case that the rising compliance costs associated with the selling of financial services products since the late 1990's has proved to be a significant extra burden for small companies, and one which they have found it increasingly difficult to bear. Combined with the growth in the number of jobs available in large companies, this may have led some owner-managers of these small companies to move back into direct employment. Once again, however, this explanation is speculative and more data relating to this area needs to be collected.

Examining the international aspects of the Scottish financial services sector, the April 2005 Scottish Economic Report also reveals that inward investment is becoming an increasing feature within the Scottish financial services sector, with 7.8% of employment being accounted for by companies based overseas. One of the most rapidly growing of these companies is the Dutch firm Aegon which, following its takeover of Scottish Equitable in 1998, has increased its employment in Scotland from 2,609 to 4,541 people. Another recent inward investment in Scotland has been made by the US company StateStreet, which is also expanding at the present time.

Similarly, it is apparent that Scotland both imports and exports financial services to other parts of the world. Using the latest figures available to the Scottish Executive, those for 2001, it is estimated that 14% of Scottish financial services output is exported to the rest of the world (excluding the UK). In contrast, Scotland is estimated to import just 2% of its financial services requirements. Thus financial services make a net contribution to the Scottish economy in terms of its external trade balance, and so provide capital for further growth generation.

In conclusion, therefore, the evidence presented in this section indicates that the financial services sector makes a significant contribution to the Scottish economy in terms of gross value added, employment and trade. One possible cause for concern, however, is that the growth in gross value added appears to be more stable than the growth in employment, which raises the question of whether there is some element of capital-labour substitution taking place in order to raise productivity. If so, then this may negatively impact on employment in this sector in the future even if the growth generation capacity of financial services remains as strong as at present.

The Future of Financial Services in the Scottish Economy

This section examines the Scottish Executive's current strategy in relation to the financial services sector, and identifies a number of potential opportunities for, and threats to, both the sector itself and the successful implementation of this strategy. During the evolution of this strategy, a strong emphasis was placed on the involvement of the private sector in terms of both policy development and delivery. Consequently, the strategy itself represents a strategic alliance between the public and private sectors of a type that is increasingly being discussed but less frequently being implemented.

As noted above, financial services already have a significant profile in Scotland in terms of both employment and contribution to output and gross value added. The Scottish Executive's strategy for the development of financial services is therefore based on consolidating existing activity, while creating a suitable business environment to allow future expansion to take place. The importance of the growth of indigenous financial services firms is recognised in this strategy, as, although small financial services firms may be more prone to closure, the effect of the loss of large, inward investing financial services organisations on the Scottish economy may be disproportionately greater than the effect resulting from the loss of a number of small firms. Consequently the Scottish Executive, in developing its financial services strategy, has had to consider a range of issues that affect a wide diversity of types of companies, both by size and industry sub-sector. In order to do so effectively, it engaged in a wide-ranging consultation across the financial services sector in order to determine the key measures that the sector itself would like to see in order to create a more conducive environment for business expansion.

The process of developing "A Strategy for the Financial Services Industry in Scotland" (Scottish Executive, 2005) began in September 2003 with the creation of the Financial Services Strategy group, which was jointly established by the public and private sectors. Chaired by Scotland's Minister for Enterprise, Jim Wallace, this group drew on a range of expertise both from within government and across the financial services industry in order to identify the key factors that would affect the future of the industry. The importance of maintaining the Edinburgh-Glasgow nexus as the second largest provider of financial services in the UK was explicitly stated, particularly in the face of increasing competition from Leeds and Manchester, although it was acknowledged that London would remain as the UK's dominant location for financial services firms for some time to come.

The existing strengths on which the industry can build have been the subject of recent scrutiny by Scottish Financial Enterprise (www.sfe.org.uk/info/overview_scottish-financial_industry). They note that banking is the dominant part of the Scottish financial services sector, with Scotland ranking second only to London in the European league table of headquarters locations of the 30 largest banks in Europe. In total, four banks are headquartered in Scotland – Royal Bank of Scotland (the world's fifth largest bank), HBOS, Scottish Widows bank and Standard Life bank. The insurance sector is also strong in terms of fund value, with a total of £640 billion being managed by Scottish based life assurance companies, of which over £200 billion is managed directly in Scotland. A further £300 billion of funds are attributable to the country's investment management centres, with asset servicing companies contributing a further £300 billion in terms of funds under administration in Scotland on behalf of companies across the world. The "Strategy for the Financial Services Industry in Scotland" was designed to build on this base in order to further enhance the development of the Scottish financial services sector.

The vision set out as part of the strategy is of "An innovative, competitive and thriving international financial services industry in Scotland, underpinned by world-class infrastructure and universally recognised as a leader on the global stage" (Scottish Executive, 2005). In order to achieve this, three strategic aims were identified in terms of "partnership action to strengthen the world-class workforce and improve the business infrastructure; build the industry's profile within and beyond Scotland; and support and encourage innovation within industry" (Scottish Executive, 2005).

The first of these aims encompasses the issue of the quality of the workforce that was referred to earlier, although obviously this in turn impacts upon the other two aims in terms of building the industry profile and encouraging innovation, both of which would be easier to achieve with a more highly skilled workforce. The Strategy report provides a snapshot of the current (2004) qualifications of the staff in the industry, which is reproduced in Table 3 below. Further development of the workforce's skills form a key part of the strategy.

Table 3 demonstrates that workers in the financial services sector have higher qualifications on average than staff across the Scottish economy as a whole and that there are proportionately fewer unskilled jobs in comparison to other sectors. Almost a quarter of financial services staff hold a degree, and over a third have some form of higher education qualification. A further third of staff hold 'A' level or equivalent qualifications, including Scottish Highers, while less than one per cent of staff have no 'O' grade or GCSE qualifications.

Table 3 Qualifications of Financial Services Employees

Qualification	Scotland Financial Services	Scotland Financial Services	Scotland – All Sectors
	Number	% of Sector	% of Sector
Above NVQ4 - Degree or Higher Degree	28,000	24.1	17.8
NVQ4 - Higher Education below degree	16,000	13.4	15.3
NVQ3 - 'A' level or equivalent	41,000	35.0	30.4
NVQ2 - GCSE A-C or equivalent	21,000	18.3	15.7
NVQ1 – below grade 1 or equivalent	1,000	0.9	3.2
Other qualifications*	10,000	8.3	17.6
Total	117,000	100.0	100.0

* professional, vocational and foreign qualifications that are not matched to NVQs.
(Source: Labour Force Survey, November 2004)

In comparison to the UK financial services sector as a whole (not shown in Table 3), a slightly smaller proportion of staff have a degree (24.1% in Scotland compared to 25.3% for the UK as a whole), but Scotland has significantly fewer staff with NVQ2 or below than is the case for the whole of the UK (19.2% compared to 31.7%). This again may reflect the different nature of jobs in the sector across different parts of the UK and is an area for further study.

In terms of the geographical distribution of financial services jobs within Scotland, the Strategy report also notes the presence of a strong cluster of employment in the Central Belt, with correspondingly lower levels of activity elsewhere. This may mean that agglomeration economies are present in this area, for example in terms of an appropriately skilled workforce, but once again this is an area for which more data needs to be collected. A central geographical location might have been expected to be less important than previously due to improved communications, for example via the internet, but there is little apparent evidence of this within the context of this report. Indeed as noted below, a key part of the proposed Scottish Strategy for Financial Services involves the improvement of physical infrastructure, which suggests that the industry itself sees physical links to be important as well as improvements to information technology networks. Again, the reasons for this require further investigation. The Strategy appears to accept the inevitability of this clustering of activity and to portray it in a positive light, in contrast to the current plans to disperse government related activity across Scotland in order to reduce inequality between the regions. This perhaps reflects an acceptance of the fact that attempting to relocate private sector activity is both difficult to put into practice and potentially damaging to any economy, in that attempts to encourage relocation within a country may lead companies to look at other locations internationally as well. Consequently it may be that it is better to let private sector organisations locate as they wish within

Scotland, even if this means significant co-location within the Central Belt, rather than attempting to obtain a more geographically spread distribution of employment.

Perhaps with this in mind, the principal focus of the Strategy for the Financial Services Industry in Scotland document is on creating a suitable climate in which businesses within this sector can thrive, particularly given the acceleration of global competition within this sector. The growth in the off-shoring of financial services back office functions is seen as a particular threat, and one which will need to be counteracted to some degree. Consequently, identification of the factors that will encourage financial services firms to locate, grow and/or remain in Scotland are a key part of this strategy. Specifically, these factors have been identified as follows:

- To create a transport infrastructure which supports the needs of the financial services industry
- To ensure continuous mobile telecommunications between and around Edinburgh and Glasgow, and improved links across other areas of Scotland
- To develop a planning framework that supports the development of the financial services industry
- To maintain a business friendly regime to enhance Scotland's competitiveness as a financial services location
- To develop and disseminate a range of labour market initiatives designed to improve the Scottish skills base and to tackle any mismatches between the supply of and demand for labour relating to the financial services industry
- To ensure a sufficient supply of suitably talented people to meet the current and future needs of the financial services industry in Scotland including via the Fresh Talent initiative
- To improve the financial literacy of Scotland's population
- To enhance communication between the financial services industry's stakeholders in order to present a co-ordinated Scottish voice on matter affecting the industry, for example with respect to UK and EU regulation
- To promote Scotland effectively as an investment location for financial services, and as a sector in which people wish to work
- To encourage both product and process innovation within the financial services sector as a means to create competitive advantage over companies elsewhere
- To strengthen and further develop the Scottish supply network for the financial services industry
- To reap the benefits of industrial clustering in the Edinburgh-Glasgow nexus as a further source of competitive advantage
- (Scottish Executive, 2005)

In order to define and develop these aspects of the Strategy, a new Financial Services Advisory Board (FiSAB) has been created to identify and implement key actions on an annual basis. This Board is once again designed to work across the industry and across a range of government organisations, such as the Scottish Executive and Scottish Enterprise, in order to achieve its goals. The first step towards this process was the publication of a First Year Implementation Plan in March 2005 (Scottish Executive, 2005a), which includes a number of specific actions to be undertaken in the short, medium and long-term. At time of writing, it is obviously too early to evaluate the (probable) success of the initiatives identified, as progress on these will be ongoing for many years to come. The plan itself is ambitious, and in some elements will require significant, and continuing, investment by the private sector. The extent to which the apparent existing consensus between all parts of the industry and government will be maintained as new challenges emerge is an area for debate, but at present the industry itself appears to be reasonably positive in this regard. It should be noted, however, that at present the industry is currently in a relatively stable growth phase and that any subsequent downturn in its fortunes may stretch this agreement significantly further. The success or otherwise of the new strategy remains to be seen, and once again this will be the subject of future research in this area.

Conclusion

This paper has provided the first step on the road to a further examination of Scotland's financial services sector with a view to understanding its potential to create future growth and employment for the Scottish economy. The perceived importance of this role is manifested in the 'Strategy for the Financial Services Industry in Scotland' (Scottish Executive, 2005), which is supported by both the public and private sectors, and encompasses a wide range of companies across the sector. This strategic alliance of organisations is strongly focussed upon developing a suitable and sustainable environment for the Scottish financial services sector in terms of transport, communications, regulation and the development of a suitably skilled workforce. The Strategy itself is still very much "work in progress" at this stage, with the first year implementation plan having only been published in March 2005. Consequently, the principal direction for future research arising from this paper is to monitor the progress of this strategy and its success in delivering the right environment for a further expansion of the financial services sector. In addition, as the acceptance of this strategy by financial services companies will be a key determinant of its success, another area for further research will be to ascertain the extent to which knowledge of the strategy and its implications have been disseminated successfully among Scottish financial services firms, and governmental organisations, in order to ensure that the appropriate level of "buy-in" to the strategy has been achieved.

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