The City of London Law Society

4 College Hill
London EC4R 2RB

Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 – Cheapside 2

mail@citysolicitors.org.uk

www.citysolicitors.org.uk

Tom Dodd
Debt and Reserves Management
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

By post and by email (thomas.dodd@hmtreasury.gsi.gov.uk)

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Dear Sir

Re: The Scotland Act 2012 – Bond Issuance by the Scottish Government

The City of London Law Society ("CLLS") represents approximately 15,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees. This response in respect of the Scotland Act 2012 Bond Issuance by the Scottish Government consultation has been prepared by the CLLS Financial Law Committee.

We are lawyers and many of the questions are economic in nature, so we shall not comment in detail. Our members have however extensive experience in advising on international finance including both sovereign and sub-sovereign debt issues and on the compositions involved where sovereign and private sector debtors are unable to meet their obligations in relation to bond issues. We comment from that perspective.

"Federal" Issues

The UK, since the Act of Union, has been one State to a very large degree, despite preserving separate legal jurisdictions in Scotland and Northern Ireland. With the devolution of powers to assemblies in Scotland, Northern Ireland and Wales, the UK now more closely resembles a federal structure. Typically federations allow borrowing by their constituent states, usually without any guarantee from the federal authority. They may also be prepared to allow a constituent state to fail and to make a separate compromise with creditors (e.g. the District of Columbia in the USA). The UK did not intervene to assist creditors of local authorities whose derivative obligations were declared ultra vires – but this does not have the same impact as failing to meet a valid obligation for which an implicit guarantee may be thought to exist.

A failure of a federal state to assist creditors of a major division of that state is, however, a difficult thing to do, even where there is no explicit obligation to do so. There would be implications for social welfare in the relevant division, greater dependence on the federal state going forward and potentially a loss of confidence by lenders affecting other parts of the federal state.

Currency Union

The UK is also a currency union, so that the status of the currency is, to a degree, bound up with the solvency and reliability of the State and its major constituent parts in paying their debts. The Eurozone provides a striking current example of the repercussions, even in financially strong states, of the difficulties of the weaker states, particularly Greece. Not only has there been a substantial divergence in borrowing costs for different parts of the Eurozone, but the weakness of the poorer states has begun to affect the economic growth of the stronger economies. While this is exacerbated by a lack of central direction, which would not be the case in the UK, it gives a fine example of the perils of separate State spending and borrowing. It does not encourage optimism that individual States always exhibit a sense of responsibility to others in their fiscal management, including borrowing on the markets.

Cost of Borrowing

It is not surprising that, as the consultation paper reports, sub-sovereign debt is generally significantly more expensive than that of the states to which the borrowers belong. Although there is some evidence of increased fiscal responsibility in the case of North American sub-sovereign borrowers, it should be remembered that powers of borrowing and taxation were a part of the sovereignty of US States <u>not</u> surrendered when the United States federation was formed and the US States retain more substantial fiscal powers than many similar sub-sovereigns. There is thus an established market which understands the risks and a body of states used to exercising independent fiscal discipline within a federal state and a currency union. Failures have involved relatively small parts of the federation as a whole.

The Scottish Government has no history of exercising borrowing powers and does not yet have an extensive track record in other aspects of fiscal management. Although not containing a high proportion of the population of the UK, it occupies a relatively large geographical area, including some with the most difficult communications systems.

We would therefore expect Scotland to have a lower international credit rating than the present UK rating, to pay a premium for directly borrowed debt and to suffer from limited liquidity in the markets as described in the consultation paper. It must be doubted if the extra cost occasioned by these factors would be a reasonable one for Scotland to bear, especially if cheaper funds are available through the National Loans Fund ("NLF").

Central Government Guarantee

As regards the UK as a whole, we would expect markets to react in the same way as towards Spain and Australia where, in the end, central government support, e.g. through the Bank of England or by increased grants to Scotland might be expected.

Given the current debate on devolution, lenders would wish to be clear whether they were lending to a part of the United Kingdom, or were at risk they would find themselves having lent to an independent sovereign state with a very different economic profile to England (by far the largest component of the United Kingdom) but with two of the UK's largest banks headquartered in Scotland and potentially coming under Scottish regulation.

In these circumstances there may be market pressure for guaranteed lending only, so long as it is unclear whether Scotland may leave the UK during the life of any proposed lending. This might still be more expensive than borrowing by the UK and on-lending to Scotland (cf. Network Rail borrowing, which, as the consultation paper notes at paragraph 2.17, carries a premium over UK gilts despite having a full government guarantee). There would be some risk of read-across to UK funding costs, even though objectively difficult to justify. Against the background of the continuing uncertainty about the Euro and the probability that the cost of Scottish bonds would be significantly greater than borrowing via the NLF, as well as the uncertainty occasioned by the planned referendum, we would suggest that now is not the time to grant these borrowing powers. The matter should be considered again after 2014 in the light of prevailing conditions.

We would be happy to discuss these views further. Please contact the Chairman of the Financial Law Committee, Dorothy Livingston at Herbert Smith LLP (dorothy.livingston@herbertsmith.com) if you would like to do this.

Yours faithfully

Dorothy Livingston
Chair, Financial Law Committee

(The names of the members of the CLLS Financial Law Committee are available on the CLLS website.)