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SCOTTISH INDEPENDENCE? THE IMPACT ON ASSETS, LIABILITIES AND CURRENCY

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SCOTTISH INDEPENDENCE? THE IMPACT ON ASSETS, LIABILITIES AND CURRENCY

If Scotland were to vote for independence from the rest of the United Kingdom, the UK's assets would need to be divided between the two countries. The most difficult decision that Scotland would face is over its currency. Cautious voices recommend maintaining sterling for a lengthy period, but others want Scotland to have its own currency at, or shortly after, independence.

In our previous two briefings in this series, we have looked at how Scotland could hold a valid independence referendum (probably only with Westminster legislation), when it might be (before the end of 2023) and when independence might occur (before the next Scottish elections, in May 2026). We also looked at how independence would affect laws in Scotland and the rest of the United Kingdom (rUK), as well as individuals and companies on either side of the border.

We turn now to the division of the UK's assets and liabilities between rUK and Scotland and, probably the most difficult issue that would face an independent Scotland, its currency. We also consider the effect of independence on contracts.

The UK's assets and liabilities

Scottish independence would require the assets and liabilities of the United Kingdom to be split between rUK and Scotland. The House of Lords Select Committee on the Constitution explained, prior to the first referendum, that:

> "The key principle governing the apportionment of assets and liabilities is that they should be shared equitably between the continuator and the successor states. It is a legal principle that fixed or immovable assets (such as Government or military buildings) would automatically become assets of the state in which they were located. Other, moveable assets (such as military equipment) would become subject to apportionment through negotiations – with the only applicable legal principle being that the apportionment should be equitable. Liabilities would be similarly subject to apportionment through negotiations."

The prevalent view was that apportionment should be on the basis of population, rather than, say, spending or tax revenue. The purpose of independence is not to perpetuate or undo fiscal transfers that have already taken place between Scotland and rUK, but to separate the two populations for the future.

The Scottish Government identified certain of the United Kingdom's assets that it would like, such as military hardware and foreign embassies. The assets that must be split between Scotland and rUK encompass property of every kind, including gold and foreign currency reserves, intellectual property, staff, software and computer systems, works of art, shareholdings, contracts, and the seabed.

This last aspect (the seabed) could prove particularly contentious because of the oil and gas below it. There are, however, reasonably well-established, if not easy to apply, principles of public international law upon which the seabed is divided between neighbouring states. If Scotland and rUK cannot reach agreement, it may be that this issue could be resolved through arbitration or other legal means. Indeed, many issues that might arise between Scotland and rUK could ultimately be referred to a third party for resolution. For example, the Anglo-Irish Treaty of 1921 establishing the Irish Free State provided for the Irish Free State to assume part of the United Kingdom's public debt, the amount to be determined by arbitration in default of agreement.

The major, but not the only, liability of the United Kingdom that must be divided between Scotland and rUK is the UK's national debt (other debt includes, for example, long-term pension liabilities and the UK's obligations to the EU under the

Withdrawal Agreement). The UK Government said at the time of the first referendum that there would be no formal transfer to Scotland of any part of the national debt; rUK would remain liable but Scotland would indemnify rUK in respect of a certain proportion of the debt. This would involve discussion of what amount Scotland should take, what maturities should be allocated to Scotland, what interest rates, what currencies and so on. rUK may even consider seeking security for Scotland's obligations (e.g. gold reserves allocated to Scotland could continue to be held by, and pledged to, the Bank of England, though these would only secure a fraction of Scotland's likely debt to rUK).

How assets and liabilities are divided affects business in different ways. The UK's commitment to continue as the obligor on existing UK Government debt may reassure creditors, although independence could have some impact on the credit standing of the rUK Government and of rUK businesses whose credit is linked to their sovereign's credit. The split of assets and, more importantly, liabilities and the impact on the credit standing of the Scottish Government will be more critical for current and future creditors of the Scottish Government – and at least some Scottish businesses – in international capital markets.

Currency

"... by laying sole claim as the continuing state to the public asset of the Bank of England, it would see [rUK] take full responsibility for the £1.6 trillion national debt." So said Alex Salmond, Scotland's First Minister at the time of the 2014 referendum, linking Scotland's willingness to accept a share of the UK's debt to rUK's agreeing to enter into a formal currency union with Scotland (the debt is now well over £2 trillion). His argument that rUK was obliged to enter into a currency union with Scotland rested on the assertion that the Bank of England, as the issuer of sterling, is an asset of the United Kingdom, not of rUK alone. As such, Scotland would be entitled to the continued use of this asset, namely sterling.

The UK Government and most commentators dismissed this argument, and all major UK national political parties stated that they would not support rUK's entering into a currency union with Scotland. A currency is a medium of exchange, a store of value and a unit of account, not an asset that appears on a balance sheet and that can be divided. The Bank of England is one of the institutions of the UK's Government which, by opting out of the UK, Scotland would have foresworn. For example, Scotland might be entitled to some of the UK's foreign embassies, but it would not be entitled to use in perpetuity the services of the Foreign, Commonwealth and Development Office.

As a result, the SNP's position appears to have changed. It set up a Sustainable Growth Commission to look at economic issues arising on independence, including currency, which reported in May 2018. The SGC took a very cautious approach as regards currency, determined not to alarm investors, holders of accounts at Scottish banks or others.

The SGC recommended that Scotland should continue unilaterally to use sterling for "a possibly extended transition period" after independence, only moving to a Scottish currency when six tests were met. The SGC considered that it was unlikely that its tests would be met until towards the end of the first decade following an independence vote. The chair of the SGC was quoted as saying that rushing into a new currency would be "short-term risky, politically difficult, and it would make the cost of Government borrowing much more expensive… The monetary policy situation that we have should continue until such a time that it's no longer in our interests."

The SGC's six tests included: fiscal sustainability, including credible budget deficit and debt levels; a credible Scottish central bank and stability in the price of Governmental debt issuances; sufficient foreign exchange and financial reserves to allow currency management; and Scotland's economic cycle moving away from rUK's such that an independent monetary policy was feasible and desirable.

The SGC recommended that any new currency be pegged at 1:1 with sterling in the short and possibly medium term, that

Some businesses, may face mismatches between the currency of assets and liabilities that may be difficult to hedge

the currency used in private contracts should not be changed retrospectively by Scottish legislation (i.e. contracts, such as loans and bank deposits, in sterling should continue in sterling), and that individuals and companies should be free to continue to use sterling in Scotland if they so wished. The SGC concluded that it would be impractical to impose capital controls to protect a Scottish currency.

The SGC's approach would leave Scotland without any influence over rUK's (and therefore Scotland's) monetary policy, without its own central bank and without any access for its financial institutions to the Bank of England as lender of last resort for a significant period of time. A foreign currency is used domestically in this way by, for example, Montenegro, which uses the euro, and Panama, which uses the US dollar. Even some larger countries, such as Ecuador, use the US dollar, issuing only local coins.

The SGC's proposal was rejected at the SNP's conference in April 2019. The conference passed a resolution to "authorise the preparation of a Scottish currency as soon as practicable after a vote for independence." This, presumably, contemplates replacing sterling with a new currency at, or shortly after, independence.

The success, or otherwise, of the SNP's conference policy would depend upon the perception of a new Scottish currency. If it was perceived that the new currency would be strong (at least, stronger than sterling), there would be fewer problems. Parties would, in general, be content to move sterling assets, including bank accounts, into the Scottish currency, and creditors would be positively keen for contracts to be redenominated. But even in this situation, parties could face a risk that does not now exist if their assets and liabilities no longer matched in currency terms.

If, however, the perception was that a Scottish currency would devalue against sterling, individuals and enterprises may take steps to ensure that sterling assets remained as such and could not be converted into the Scottish currency (e.g. by mandatory conversion of all bank balances) or trapped in Scotland (e.g. by capital controls). Deposits at banks in Scotland might, for example, be moved to banks or branches in rUK or elsewhere, potentially creating an immediate liquidity crisis at banks in Scotland, as well as a shortage of foreign currency reserves The formal currency union between the Czech Republic and Slovakia in 1993 survived only five weeks, as monies flowed from Slovakia to the Czech Republic, which was regarded as the economically stronger of the two.

In any event, the introduction of a new currency is likely to give rise to issues for some businesses or individuals, whether or not Scotland mandates the redenomination into the new Scottish currency of obligations under some or all existing contracts. Some will end up facing mismatches between the currency of assets and liabilities or future income and outgoings that will be difficult or expensive (even, perhaps, impossible) to hedge. These impacts are likely to be most significant for businesses that are highly leveraged (such as banks), operate in both Scotland and rUK or have assets or liabilities that are governed by both Scottish and English or other laws. These issues are reduced by a long transition period with a 1:1 peg as shorter term contracts can be run-off and parties can readjust their positions but are increased if there is a more rapid transition.

Currency is one of the hardest issues an independent Scotland would face. It is understandable – indeed, it is to be expected – that a new country would want its own monetary policy, rather than be beholden to the state it has rejected. This requires a currency, but launching a new currency into the global financial markets involves considerable risks, as the SGC recognised, not least in the light of the current deficit in Scotland's public finances and the (post COVID-19 pandemic) debt it would inherit from the UK.

Contracts

Scotland already has its own laws and legal system. Contracts expressed to be governed by Scottish law would continue to be governed by Scottish law, and contracts expressed to be governed by English law would continue to be governed by English law, even if the counterparty is Scottish. Subject to any legislation that Scotland may introduce in respect of contracts governed by Scottish law and that rUK may introduce in respect of English law contracts, pre-independence contracts would remain as binding after independence as they were before.

The uncertainty over Scotland's currency may, however, introduce performance or execution risks for contractual counterparties. For example, if performance of a contract must take place in Scotland, a Scottish overriding mandatory law could affect, say, the ability to pay in sterling. Similarly, Scottish laws could determine the exchange rate at which a debt due in sterling was converted for enforcement or other purposes in Scotland. If sterling is the currency of account in a contract with strong links to Scotland, a new Scottish currency could lead to an argument that this new currency, rather than sterling, becomes the unit of account.

To consider these risks, parties would need to look at the terms of their existing contracts (e.g. Where is payment due? Is there a definition of sterling?). They may also need to consider the drafting of future contracts to ensure, for example, that sterling is adequately defined and that payments are to be made outside Scotland. Similarly, although the mere fact of the creation of an independent Scotland is unlikely, of itself, to trigger a contractual default (absent any specifically drafted provision), parties may want to review covenants, undertakings and events of default in commercial contracts, bonds, loans and swaps.

In addition, anyone with a contract with the UK Government or a public sector institution needs to consider how the contract will be affected by Scottish independence. If the contract relates only to services in England, the contract will probably continue as before. But if the contract has a Scottish element, can Scotland take the benefit of the contract or any part of it should it wish to do so? Will renegotiation be required? Can rUK, Scotland, or both, make use of software licences for systems each wishes to continue to use?

Other cross-border elements may also create issues. For example, if the contract provides for the delivery of goods or provision of services between Scotland and rUK, the contract may not anticipate the impact of new tariff or non-tariff barriers to cross-border trade that come into effect after independence.

Defending the borders

In its preparations for the first referendum, the Scottish Government pointed out that, in 2007, the UK Government valued its military assets at £93 billion. Splitting this on a population basis would give Scotland a £7.8 billion share on independence.

The Scottish Government then earmarked certain assets it would like within its share, such as two frigates, four mine counter measures vessels, two offshore patrol vessels, two light artillery units, six helicopters, at least 12 typhoon jets and, within a decade of independence, 15,000 service personnel.

What the Scottish Government did not want was the Trident nuclear deterrent. It wanted an "early agreement on the speediest safe removal of nuclear weapons", and would make this a "priority for negotiations" with rUK. To emphasise its determination, it identified Faslane, the home of Trident, as the headquarters of the new Scottish defence forces. Given the lack of any obvious other venue for rUK's nuclear weapons, this could, at an early stage, make the negotiations between Scotland and rUK highly contentious.

Conclusion

Whether and, if so, when to create its own new currency will probably be the most complex issue facing a newly independent Scotland, but it is potentially also the most far-reaching.
An independent Scotland will, understandably, want control of its monetary policy, but moving to its own currency is likely to prove a very challenging task.

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