BLUEPRINT FOR A SCOTTISH NATIONAL INVESTMENT BANK

Written by: Laurie Macfarlane

Registered charity number 1055254
© 2016 The New Economics Foundation
New Economics Foundation (NEF) is the only people-powered think tank. We work to build a new economy where people really take control.

Common Weal is an independent Scottish think and do tank that campaigns for greater social and economic equality.
# CONTENTS

1. EXECUTIVE SUMMARY ..............................................................................................................4  
2. INTRODUCTION ..........................................................................................................................6  
3. THE NEED FOR A SCOTTISH NATIONAL INVESTMENT BANK ...........................................8  
   3.1 SCOTLAND’S UNDERINVESTMENT PROBLEM ....................................................................8  
   3.2 INFRASTRUCTURE INVESTMENT .......................................................................................9  
   3.3 LONG-TERM INVESTMENT IN BUSINESS ........................................................................12  
   3.4 INNOVATION AND SOCIAL AND ENVIRONMENTAL GOALS ........................................13  
4. MANDATE AND ACTIVITIES ......................................................................................................15  
   4.2 BUSINESS INVESTMENT ....................................................................................................18  
   4.3 INNOVATION AND SOCIAL AND ENVIRONMENTAL GOALS ........................................19  
5. OWNERSHIP AND GOVERNANCE ............................................................................................21  
   5.1 OWNERSHIP AND BUSINESS MODEL .............................................................................21  
   5.2 GOVERNANCE ....................................................................................................................22  
   5.3 MEASURING SUCCESS ........................................................................................................24  
6. FINANCIAL ISSUES ....................................................................................................................25  
   6.1 CAPITALISATION AND START-UP COSTS .......................................................................25  
   6.2 FUNDING ............................................................................................................................27  
   6.3 ECONOMIC BENEFITS ........................................................................................................28  
7. IMPLEMENTATION ISSUES .........................................................................................................30  
   7.1 SECTOR CLASSIFICATION .................................................................................................30  
   7.2 UK NATIONAL ACCOUNTING RULES ................................................................................30  
   7.3 SCOTTISH BUDGETARY RULES .......................................................................................32  
   7.4 EU STATE AID RULES .......................................................................................................32  
   7.5 REGULATORY CONSIDERATIONS ....................................................................................33  
8. CONCLUSION .............................................................................................................................35  
ENDNOTES ....................................................................................................................................36
1. EXECUTIVE SUMMARY

Investment – both by the private sector and by government – is crucial to the long term economic, social and environmental health of any economy. As part of the UK, Scotland has a longstanding problem of underinvestment relative to other countries. This has contributed to low levels of productivity, growth and innovation. It has its roots in a combination of both lower public sector support in the provision of long-term “patient capital”, and a banking and corporate sector that is focused more on short-term shareholder returns than its foreign counterparts. Although the Scottish Government’s Economic Strategy identifies investment as one of four priority areas, boosting investment will be challenging in an environment of declining budgets, economic uncertainty, limited government borrowing powers and growing problems with public private partnership schemes. As a result, the need for fresh thinking on how to increase investment in Scotland has never been greater.

In many countries national investment banks play a key role in financing and directing investment. In this report we develop the arguments for a Scottish National Investment Bank (SNIB) and, drawing on academic and policy literature and evidence from other countries, set out in greater detail than in previous papers what a SNIB might look like and how it could be established in the Scottish political, legal and economic context. Our vision for a SNIB is summarised as follows:

- **Mandate**: The SNIB’s overarching mandate should reflect a broader economic strategy developed in a democratic process, controlled by the Scottish Government, and reviewed periodically.

- **Activities**: The core activities of a SNIB should be to support investment in infrastructure and SMEs and to direct investment towards innovation for social and environmental objectives, such as accelerating the transition to a post-fossil fuel economy.

- **Ownership**: The SNIB should be publicly owned but operated independently as a fully commercial entity, free of day-to-day political interference.

- **Governance**: Robust ownership and governance structures should be put in place which promote the highest levels of transparency and accountability, and provide a clear dividing line between the government and lending decisions.

- **Capitalisation**: The Scottish Government should inject £225m of ‘paid-in’ capital with that accumulated figure over six years being ‘subscribed’, giving a total subscribed capital of £1.35 billion from year one.

- **Funding**: The SNIB should be allowed to raise funds on capital markets by issuing bonds up to a leverage ratio of 2.5 times the amount of subscribed capital,
meaning it could raise £3.37 billion that would be available finance for SNIB loans from year one.

Other practical issues which need to be addressed in setting up a Scottish National Investment Bank include:

- **Accounting:** The Scottish Government should request changes to budgeting rules to ensure that the lending activities of the SNIB does not score against expenditure limits and divert money from public services.

- **EU state aid approval:** Securing EU state aid approval would require that the SNIB’s lending is additional i.e. focused in areas that are currently being underserved by the private sector.

- **Regulation:** The SNIB would likely need to be authorised and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

A SNIB along these lines would help narrow the gap in Scotland’s productivity performance, boost export activity, diversify and expand the business base and speed up the transition to a low carbon economy. In doing so, it would support the creation of over 50,000 new jobs.

It would also generate billions of pounds of savings for the public purse by providing a low cost alternative to expensive private public partnership schemes. To illustrate the scale of the potential benefit to the public finances, we estimate that the Scottish Government would have saved a total of £26 billion if the projects financed through Private Finance Initiative (PFI) and Non-Profit Dividend (NPD) schemes had instead been financed by a SNIB.
2. INTRODUCTION

In March 2016 the New Economics Foundation (NEF), Friends of the Earth Scotland, Common Weal and Move Your Money published Banking for the Common Good – a discussion paper which outlined a new vision for banking in Scotland\(^1\). A key part of this vision was the establishment of a Scottish National Investment Bank (SNIB).

The fundamental role of national investment banks is to leverage relatively small amounts of public capital into a significant source of strategic and long-term finance that can be channelled into areas of the economy in most need. In many countries national investment banks play a key role in financing and directing investment. They are widely recognised as having played a crucial role in the economic development of many advanced economies throughout the twentieth century and continue to do so today in countries such as Germany, Japan and the Nordic nations.

In recent years there has been considerable debate regarding the formation of a national investment bank in the UK context. Several proposals for a publicly owned investment or business bank have been published, including:

- Robert Skidelsky, Felix Martin and Christian Wigstrom’s Blueprint for a British Investment Bank (November 2011)\(^2\)
- David Merlin-Jones’ Extending Lending: The Case for a State-backed Investment Bank (February 2012) published by Civitas\(^3\)
- Nick Tott’s Case for a British Investment Bank (June 2012) published as part of the Labour Party’s policy review\(^4\)
- Tony Dolphin and David Nash’s Investing for the Future: Why we need a British Investment Bank (September 2012) published by the IPPR\(^5\)
- The British Chamber of Commerce’s Case for a British Business Bank (September 2012)\(^6\)
- The New Economics Foundation’s proposals for the British Business Bank (September 2013)\(^7\)
- The LSE Growth Commission’s recommendation to establish a national Infrastructure Bank\(^8\)

In addition to Banking for the Common Good, there has also been a growing body of research on how establishing such an institution in Scotland could provide significant benefits to the Scottish economy:

- Ian Cairns’ proposal for a State-Owned Investment Bank for Scotland (March 2013)\(^9\)
• Iain Cairns, Christine Cooper and Gordon Morgan’s proposals outlined in ‘Investment in Scotland: A Common Weal Approach’ (September 2014)\textsuperscript{10}

As such, the theoretical merits of such institutions will not be repeated in this report. Instead we seek to further develop the arguments for a Scottish National Investment Bank (SNIB) and set out in greater detail than in previous papers what a SNIB might look like and how it could be established the Scottish political, legal and economic context. Drawing on academic and policy literature and evidence from other countries, the report seeks to address the following questions:

• What should the mandate of a SNIB be?
• What should the ownership structure and business model of a SNIB be?
• What would the optimal governance arrangements of a SNIB be?
• How would a SNIB be capitalised?
• How would a SNIB raise finance to channel investment into the Scottish economy?
• How would a SNIB interact with UK public accounting rules and the Scottish budgeting process?
• What regulatory and legal obstacles need to be considered?
3. THE NEED FOR A SCOTTISH NATIONAL INVESTMENT BANK

Investment – both by the private sector and by government – is crucial to the long term economic, social and environmental health of any economy. As will be discussed further below, Scotland has a long-standing problem of inadequate flows of socially useful investment, including in crucial areas such as research and development, housing, energy and transport infrastructure as well as continued under-investment in small and medium enterprises (SMEs). The Scottish Government’s Economic Strategy identifies investment as one of the four priority areas for generating sustainable growth, increasing competitiveness and tackling inequality\textsuperscript{11}. However, in an environment of declining budgets, economic uncertainty and limited government borrowing powers, the prospects for increasing investment looks increasingly challenging. In this section we provide an analysis of Scotland’s historic underinvestment problem and outline why a SNIB could help address this in the current economic and political context.

3.1 SCOTLAND’S UNDERINVESTMENT PROBLEM

As part of the UK, Scotland has a longstanding problem of underinvestment relative to other countries, and this has been exacerbated in recent times by recession and the UK government’s programme of austerity. The percentage of GDP invested in 2014, at 17.8 per cent, was the fifth lowest of the EU countries. Only Cyprus, Italy, Portugal and Greece were lower – all countries which have been through a period of severe economic distress. Compared with other large advanced economies, the UK has consistently underinvested relative to the size of its economy.

Figure 1: Gross fixed capital formation (% GDP)

Source: World Bank\textsuperscript{12}
This investment problem comprises three major elements: a lack of investment in infrastructure, a lack of long-term investment in business, especially small and medium-sized businesses (SMEs) and a lack of strategic investment in innovation. All of these elements have their roots in a combination of both lower public sector support in the provision of long-term “patient capital” compared to other countries, and a banking and corporate sector that is more focused on short-term shareholder returns than its foreign counterparts.

3.2 INFRASTRUCTURE INVESTMENT

Infrastructure refers to the basic structures that facilitate and support economic activity, such as roads and other transportation facilities, power generation and other utilities, and communications systems. Investing in infrastructure is crucial to the long term prosperity of any economy. As well as generating a short-term boost in aggregate demand, public investment in infrastructure improves the productive capacity of the economy, stimulates the crowding in of private business investment and widens access to the labour market, all of which help promote development at a local level. Analysis from the International Monetary Fund (IMF) shows that a 1% increase in infrastructure investment as a share of GDP leads to a direct increase of 0.4% in annual economic growth, growing to 1.5% a year within four years.

In recent years the infrastructure and construction sectors have driven growth in Scotland due to the number of large infrastructure projects being delivered such as the Forth Replacement Crossing, and the subdued activity in other sectors of the economy. However, infrastructure output is likely to decline over the next five years as several major public infrastructure projects reach completion. As part of the UK overall levels of public infrastructure investment are low on an international basis as a percentage of GDP, and the Organisation for Economic Co-operation and Development (OECD) ranks the UK second last out of the G7 countries for overall infrastructure quality.

Of the comparatively small amount of infrastructure investment that does occur in the UK, most is heavily concentrated in London and surrounding areas. As an example, in 2015-16 public infrastructure expenditure on transport per head was £2,604 in London, compared with only £170 in Scotland (see figure 2).
Scotland’s population is expected to grow by 7% by 2039 which will increase pressure on key services, particularly in areas such as housing and transport. The Scottish Government has also committed to having world class digital infrastructure through to 2020 and beyond and to ensuring that digital infrastructure improvements in rural and remote areas keep pace with the rest of the country. Meeting the challenges of demographic change and upgrading systems to meet the needs and challenges of the twenty-first century will require significant amounts of long-term and, preferably, low-cost investment.

However, across the UK infrastructure investment has become increasingly expensive. Lord Sassoon, former commercial secretary of the UK Treasury, has commented that “today the UK is one of the most expensive countries in which to build infrastructure.” A major reason for these inflated costs is the Private Finance Initiative (PFI) model which, since the 1990s, has grown to dominate the UK’s infrastructure provision. PFI financing is expensive because projects are financed with private debt and equity which is significantly more expensive than public borrowing. Governments then pay an annual charge to private contractors over many decades which covers the capital repayment plus interest and maintenance costs, and is usually indexed to inflation.

Use of PFI financing was particularly prevalent in Scotland during the period between 1993 and 2006. Data published by the Scottish Government shows that the 80 projects...
completed in Scotland during this period will cost the public sector £30.2 billion over the coming decades – more than five times the £5.7 billion initial costs associated with construction and development\textsuperscript{22}. The high-profile closure of 17 PFI schools in Edinburgh in April 2016 as a result of safety concerns from construction defects shows that in addition to being poor value for money, PFI schemes have also delivered poor and often dangerous quality standards\textsuperscript{23}.

In response to concerns around PFI, the Scottish Government developed the Non-Profit Distributing (NPD) model to fund a range of projects in three main sectors – education, health and transport. Under the NPD model there is no dividend bearing equity and private sector returns are capped, but financing is still undertaken through private loans with the expectation of a market rate of return. As such, projects funded through the NPD model are still significantly more expensive than they would be if they were funded through public borrowing. The chief executive of Scottish Futures Trust, Barry White, has stated that while the private sector’s best returns under PFI were around 15 per cent, under NPD they are still around 12 per cent\textsuperscript{24}.

Moreover, recent changes in European Union guidance on sector classification have had implications for the budgeting treatment of a number of NPD projects. In July 2015, the Office for National Statistics decided that the Aberdeen Western Peripheral Route should be classified to the public sector. This meant that £283 million of expenditure which was previously classified as being delivered by the private sector came onto the public balance sheet, and the Scottish Government had to agree exceptional arrangements with HM Treasury to allow £283 million of spending to be recorded against its borrowing limit for the year rather than its Capital Departmental Expenditure Limit budget\textsuperscript{25}. Decisions have yet to be reached in relation to a number of other NPD projects which may have a significant impact on the Scottish Government’s available capital budget.

These problems with both the PFI and NPD model highlight the need for fresh thinking around increasing public investment in Scotland. A Scottish National Investment Bank would mean that key infrastructure in Scotland could be financed far more cost effectively. The business model of a national investment bank effectively turns the PFI model upside down – instead of the private sector raising expensive capital to build assets which it then leases to the public sector, the public sector raises cheap capital to build assets which can either be retained in public ownership, sold or leased to the private sector\textsuperscript{26}.
3.3 LONG-TERM INVESTMENT IN BUSINESS

SMEs make a vital contribution to the Scottish economy. In March 2015, there were an estimated 361,345 private sector enterprises operating in Scotland, of which 359,050 were small and medium-sized enterprises (SMEs). These SMEs provide an estimated 1.2 million jobs and account for 55.6% of private sector jobs and 39.4% of private sector turnover. Banks continue to meet the vast majority of Scottish business needs for debt, through overdrafts, loans and other support such as invoice finance and asset based lending. The total SME bank loan market in Scotland was £6.7 billion in 2015 with banks also supplying £1.2 billion of overdrafts to Scottish SMEs in that period.

However, evidence suggests that there are large gaps in the market for SME finance which results in some SMEs being unable to secure the finance they need to grow and expand. The difficulty SMEs find in obtaining funding has long been recognised as a market failure since the so-called ‘Macmillan gap’ was identified by the Macmillan Commission of 1931. Information asymmetries between banks and industry combined with high transaction costs either raises the cost of finance for SMEs or makes it unavailable altogether to those without collateral.

In recent decades this problem has intensified as the UK banking sector has come to be dominated by a handful of large, universal, shareholder-owned banks. Over time the business models of these banks have shifted away from relationship based business lending in favour of short-term trading and commission-based activities, lending to other financial institutions and mortgage lending.

The result is that since the mid-1980s the share of lending going to businesses has been falling rapidly, and now represents less than 10% of total lending (see dark blue colour in figure 3). Meanwhile, lending to financial institutions (the light blue colour) for speculative trading has boosted the profitability of the financial sector, and a rapid increase in mortgage lending (the green colour) has contributed towards house prices becoming increasingly detached from earnings.
The Scottish Government estimates that the SME lending gap is currently in the range of £330 million to £750 million per year, with loans under £1 million are the hardest to obtain\textsuperscript{31}. Closing this financing gap and supporting the growth of Scotland’s SMEs could help narrow the gap in Scotland’s productivity performance, boost export activity, diversify and expand the business base and support reindustrialisation.

In recent years the Scottish Government has on numerous occasions stated an intention to establish a Scottish Business Development Bank to channel new investment into SMEs and help close the lending gap\textsuperscript{32,33}. More recently, the Scottish Government announced the creation of a new Scottish Growth Scheme which will provide up to £500 million of government guarantees and loans to SMEs with significant growth or export potential. While these initiatives are a welcome step in the right direction, we consider that closing the SME financing gap can be more effectively achieved through the establishment of a large scale multi-purpose national investment bank which can transform relatively small amounts of public capital into a significant source of finance for the Scottish economy.

### 3.4 Innovation and Social and Environmental Goals
Investment has long been recognised as crucial to the process of innovation, but economic theory has traditionally seen a limited role for the public sector in this process. Public intervention has generally been justified only in instances where markets fail to
efficiently allocate resources, as in the examples of infrastructure and SMEs outlined above. However, in recent years a growing body of academic literature has highlighted the key role that public investment plays not only in fixing market failures, but in actively creating and shaping new sectors and driving innovations targeted towards particular social and environmental objectives. As has been highlighted by economist Mariana Mazzucato, many of the most fundamental technological advances of the past half century, including the internet, microchips, biotechnology and nanotechnology, were funded in the first instance with public money. This “entrepreneurial” role of the state spurs innovation by steering the direction of investment in new directions that are seen as societally desirable.

Today many countries have policy objectives of promoting smart, innovation-led growth agendas that are intended to advance progress towards particular social and environmental objectives. These strategies (sometimes referred to as “mission-oriented” strategies) are about creating new technological landscapes and innovative solutions that are framed around ‘grand challenges’, such as those related to climate change. In countries like China, Germany and Brazil, this strategic public funding is increasingly coming from national investment banks.

Examples of this include the European Investment Bank’s €14.7 billion commitment to sustainable city projects in Europe, the efforts of the German KfW to support Germany’s energy transformation policies through the greening and modernisation of German industries and infrastructures, and the technology fund put in place by the Brazilian BDNES to support innovation in strategic sectors such as energy, environment, pharmaceuticals, electronics and transport.

A SNIB would therefore be well positioned to take on such a role in Scotland and direct investment in a smart, inclusive and sustainable direction that not only addresses market failures but also seeks to drive innovation in support of particular social and environmental objectives.
4. MANDATE AND ACTIVITIES

In light of the issues identified in the previous section, it is proposed that the core activities of a SNIB should be to overcome the dual market failures of underinvestment in infrastructure and a lack of lending to SMEs and to direct investment towards innovation for social and environmental objectives. This is a model which works well in other countries. While these different types of lending will need very different skills, all are vital for delivering the Scottish Government’s economic strategy.

In other countries national investment banks and similar institutions often have an overall guiding mandate, or a set of overarching set of economic, social and environmental objectives that give strategic direction to these core activities. Some examples are provided in table 1.

Table 1: Mandates of banks overseas

<table>
<thead>
<tr>
<th>Institution</th>
<th>Mandate or mission statement</th>
</tr>
</thead>
<tbody>
<tr>
<td>German KfW</td>
<td>To sustainably improve the economic, social and ecological condition of people’s lives</td>
</tr>
<tr>
<td>US Small Business Administration</td>
<td>To aid, counsel, assist and protect the interests of small business concerns; to preserve free competitive enterprise and to maintain and strengthen the overall economy of our nation.</td>
</tr>
<tr>
<td>BNDES (Brazil)</td>
<td>To contribute to the economic development of Brazil, including sustainable socio-economic development, technological innovation and the modernisation of public administration.</td>
</tr>
<tr>
<td>Nordic Investment Bank</td>
<td>To promote sustainable growth by providing complementary financing based on sound banking principles which strengthen competitiveness and enhance the environment.</td>
</tr>
<tr>
<td>European Investment Bank</td>
<td>To support projects which make a significant contribution to growth, employment, economics, social cohesion and environmental sustainability in Europe and beyond.</td>
</tr>
</tbody>
</table>

Source: NEF
It is proposed that the overall guiding mandate for a SNIB should reflect the Scottish Government’s wider economic strategy. At the present time, such a mandate could be:

“To promote investment across Scotland to help generate sustainable growth, increase competitiveness and tackle inequality”

However, this guiding mandate should be developed in a democratic process, controlled by the Scottish Government, and reviewed periodically. Deliberative processes like citizens’ assemblies and participatory budgeting could be used to help develop the mandate and priorities of a SNIB in a more inclusive and participatory way.

As will be discussed further in section 5, the SNIB would be organisationally independent in meeting this guiding mandate to ensure that it makes sound, long-term decisions, free of day-to-day political interference.

**Figure 4: Mandate and activities of a SNIB**

In the next three sections we provide some more information on each of the three activities that a SNIB would undertake to support its mandate.

**4.1 INFRASTRUCTURE INVESTMENT**

The SNIB’s infrastructure arm should aim to provide finance for the construction of assets that facilitate and support economic activity and which provide a future income stream from which the SNIB can be paid. In identifying projects to invest in the SNIB should aim to demonstrate that it is providing additionality i.e. that it is providing finance in areas that are currently being underserved by the private sector. As well as ensuring that the SNIB focuses on addressing the key market failures outlined in section 3, this is also important if the SNIB has to comply with EU State Aid rules (discussed further in section 7). Examples of areas in which the SNIB may choose to invest include upgrades to the energy grid, renewable and low-carbon energy projects, high-speed rail,
energy efficiency schemes, telecommunications, water and wastewater infrastructure and affordable housing.

The SNIB could invite local authorities, other public sector entities and private companies to apply for access to long-term, low-interest loans to support infrastructure development. These applications would be assessed against the criteria required by the SNIB’s mandates by in-house professional specialists with strong sectoral intelligence and financial expertise. This process plays a key role in supporting infrastructure development in other countries.

For example, in 2016 the Nordic Investment Bank invested €73 million to support new passenger trains in central Sweden, €106 million for new road connections and tunnels in southern Norway and €330 million for investment in water supply and wastewater treatment in Stockholm, including the world’s largest underground wastewater treatment facility. In 2009 the German Kreditanstalt für Wiederaufbau (KfW) announced an “infrastructure investment offensive”, targeting what it called “structurally weak regions” in Germany. To do this the KfW invited municipal authorities and companies run and owned by these authorities to take advantage of €3 billion in long-term, reduced interest loans. These are just some examples of the ways in which existing national investment banks have recently provided finance for public infrastructure.

### Case study: Scottish Water

One sector that could benefit from SNIB financing is the water and wastewater industry. Unlike in England and Wales where water and sewerage provision was privatised in 1989, households in Scotland are served by a single publicly owned monopoly provider of water and wastewater services – Scottish Water. Today Scottish Water has an annual turnover of some £1.2 billion, and is one of Scotland’s 20 largest businesses. It employs 3,600 staff and sustains a further 20 per cent of the Scottish civil construction industry. Due to the long term nature of the water industry and increasing quality and environmental standards, Scottish Water has a substantial ongoing capital investment programme. At the moment the Scottish Government lends money to Scottish Water to help finance this investment and spread the cost of new assets over their expected lifetime, and has committed to providing up to £760 million to support the delivery of the 2015-21 capital programme.

However, because the Scottish Government has limited borrowing powers, this money has to come from departmental capital budgets which are determined to a large extent by the spending decisions of the UK Government. Scottish Water repays these loans
over time from its stable revenue stream of customer charges which are set every six years by a dedicated economic regulator\textsuperscript{43}.

Scottish Water’s ongoing need for long-term finance combined with its stable and predictable revenue stream makes it an ideal candidate for SNIB financing. As well as enabling decisions around the financing of Scottish Water to be decoupled from wider Scottish Government budgetary pressures, this would free up the Scottish Government’s capital budgets for other uses.

\textbf{4.2 BUSINESS INVESTMENT}

In other countries it is common for national investment banks to provide funding to SMEs either directly through extensive branch networks or indirectly through intermediary banks that have a strong local focus. In Germany, the KfW on-lends through most banks in Germany, but mainly through the Sparkassen – local public savings banks that have historic ties to specific regions\textsuperscript{44}. Unlike high street commercial banks in the UK, they are rooted in local communities, know the sectors which they finance very well, and offer locally tailored services. The Nordic Investment Bank, on the other hand, provides credit lines to banks together with constraints on how the funds are to be used which ensures that the money finds its way to SMEs\textsuperscript{45}.

As proposed in \textit{Banking for the Common Good}, the long term aim in Scotland should be to support the establishment of a network of not-for-profit, locally-based banks, run in the interests of local communities and capitalised by local authorities, local businesses, credit unions and citizens\textsuperscript{46}. The SNIB could then provide funding to SMEs indirectly through these local intermediaries.

This is most the most effective option because local “stakeholder” banks can maintain intimate knowledge of local people and the local economy, and evidence suggests that they are better than commercial banks at seeking and assimilating the ‘soft’ information needed to holistically assess the prospects of small firms\textsuperscript{47}. Often described as ‘relationship banking’, this approach ameliorates the information asymmetry which makes SME lending unattractive to larger banks, where the drive for process efficiency and control leads to centralised systems of credit scoring that become blind to regional, local and firm specific conditions.\textsuperscript{48}

However, at present this type of local banking network does not exist in Scotland. The SNIB could play a role in helping to establish these institutions across the country by providing initial start-up capital as well as expertise and assistance to local authorities and other local stakeholders. Following this, the SNIB could provide funding to SMEs indirectly through these local intermediaries.
In the meantime, however, the SNIB could fund SMEs by employing local loan officers around the country, perhaps situating them in the local offices of Business Gateway and Scottish Enterprise. These loan officers would need to be professional specialists with detailed local knowledge and strong business acumen. Local SMEs could apply for access to long-term, low-interest loans to support working capital, capital investment, procurement or debt refinancing, and the loan officers would assess these applications on the basis of commercial viability and eligibility against the criteria required by the SNIB’s mandate.

A SNIB could also provide equity funding. Many national investment banks such as Germany’s KfW and Brazil’s BNDES do not just target market failures in the long-term loan market, but also have equity arms which provide seed money, venture capital and private equity funds\(^5\). This could most straightforwardly be achieved by merging the current Scottish Investment Bank into the SNIB. Despite the name, the Scottish Investment Bank is not technically a bank, rather it is the investment arm of Scottish Enterprise\(^6\) and more akin to a fund. Whereas national investment banks raise their own finance from capital markets and use this finance to lend money or to invest in companies or financial products, a fund such as the Scottish Investment Bank is given a fixed amount of resources from the government which it disburses as grants, loans or equity investments\(^7\).

However, the Scottish Investment Bank already houses significant expertise on the Scottish SME sector and holds equity stakes in many promising Scottish businesses. Merging into the SNIB would therefore be a logical step to maximise synergies and investment opportunities.

4.3 INNOVATION AND SOCIAL AND ENVIRONMENTAL GOALS

As the Scottish Government recognises, there is now an urgent need for interventions which incentivise the necessary transition to a low carbon economy and mitigate the risks posed by climate change\(^8\). As such, a SNIB would be well positioned to direct investment towards innovation and technologies that accelerate the transition to a post-fossil fuel economy.

One way of doing this is through the design of bespoke financial products which support this objective. For example, the German KfW offers products aimed at improving the environmental efficiency of homes and businesses, as well as programmes to support new environmental technologies and renewable energy generation\(^9\). Similarly, in June 2016 the Nordic Investment Bank launched a €500 million Environmental Bond to support its lending to selected environmental projects\(^10\).
These are just some examples of ways that a SNIB could help spur innovation and steer the direction of investment in new directions that would accelerate the transition to a post-fossil fuel economy.

**Case study: A just transition for Aberdeen**

After multiple booming decades as the home of the Scotland’s oil and gas sector, Aberdeen now faces a challenging future as lower oil prices and higher costs result in shrinking investment, job losses and stagnation. In order to ensure that the city does not enter terminal decline, many campaigners have called for a “just transition” away from oil and gas – a deliberate strategy of industrial transition to forge a new economy in Aberdeen with a focus on protecting those that will lose out. Proposals that have been suggested include developing the city into the centre of the global oilfield decommissioning industry and maximising its huge potential for renewable energy.55 Regardless of the specific strategy, it is clear that successfully transitioning Aberdeen’s economy away from oil and gas will require significant amounts of local investment. A SNIB could offer specific financial products to businesses, universities, local authorities and third sector organisations to help fund initiatives which facilitate this transition.

The Scottish Government has also set out a vision to rebalance and reindustrialise the Scottish economy by developing a strategy focussed on strengthening manufacturing; promoting innovation; and encouraging international trade and investment.56 A SNIB could support this vision by providing targeted funding for companies that are developing disruptive technologies in new sectors that are seen strategically important, such as hi-tech manufacturing.

This kind of smart, innovation led strategy helped to transform Finland’s economy in the 1990s. After suffering one the worst recessions in its history, the Finnish government responded by overhauling Finnish economic policy and setting out a vision for the country as a ‘knowledge economy’. It built on Finland’s strengths in engineering, and focused on the emergence of a cluster of telecommunications companies around the University of Helsinki. Supported by public funding, education and training, a wave of technological innovation in emerging industries transformed the Finnish economy. The result was that productivity growth rose by almost 30% over the rest of the decade, Nokia emerged as a leading mobile phone company and Finland became one of the world’s largest exporters of high-tech products.57
5. OWNERSHIP AND GOVERNANCE

Ownership and governance arrangements are particularly important for a national investment bank, to ensure that its mandate is properly pursued, and that private financial and political interests are not wrongfully prioritised. Although there are many international examples of poor governance leading to poor outcomes, there is also plenty of good practice to learn from. It is therefore essential that a SNIB has robust ownership and governance structures that promote the highest levels of transparency and accountability.

In this section we outline some principles for how this could be achieved, drawing on literature and evidence from other countries, including previous NEF research. Related to this are issues around sector classification and public accounting rules which are discussed in section 7.

5.1 OWNERSHIP AND BUSINESS MODEL

In order to ensure that the SNIB serves the long term interests of the Scottish economy, it is proposed that the SNIB should be fully publicly owned. However, the SNIB should be operated independently as a fully commercial entity to ensure that it makes sound, long-term banking decisions, free of day-to-day political interference. This independence is also essential to maintain a strong credit rating which is essential to ensure the SNIB can raise finance at low cost.

As an independent commercial entity it is proposed that the SNIB would be profit making but would not seek to maximise profits. Instead, it would set modest profit targets which would be retained rather than paid out as dividends to enable the SNIB to build reserves and expand its operations over time. As discussed further in section 6, this should also mean that the SNIB’s reliance on external financing can be lessened over time.

Public ownership will help ensure that the SNIB serves the long-term interests of society rather than the short-term pressures of maximising shareholder returns. It will also help ensure that it avoids the fate of the Industrial and Commercial Finance Corporation (ICFC) which was set up in 1945 to provide finance for SMEs and which was owned by a consortium of the ‘big five’ clearing banks and the government. In the decades that followed the ICFC was successful in fostering long-term relationships with SMEs and providing access to finance through a regional branch network. However, once the government reduced its involvement the ICFC came under increasing pressure to deliver profits and was eventually sold off as venture capital firm 3i which proceeded to focus on management buyouts. As a result, despite initial good intentions the aim of having a
dedicated organisation focused on addressing market failures in SME lending was
diluted over time\textsuperscript{59}.

5.2 GOVERNANCE
Previous NEF research which reviewed the governance arrangements in public banks
overseas drew the following broad lessons\textsuperscript{60}:

1. A clear division between a supervisory and a management board is almost
universal practice. The former can and should contain political representation (as
part of the chain of democratic accountability). The latter should contain banking
executives and external non-executives from a range of backgrounds. Where this
division has not been maintained problems have arisen, as in the case of the
‘cajas’ (Spanish savings banks)\textsuperscript{61}.
2. There is a strong case for the supervisory board to contain representatives of the
opposition as well as the governing party. Giving the opposition the chance to
test and question the bank’s strategy from the inside helps keep the management
focused on its mission, prevents collusion between government representatives
and management to depart from the mandate and makes the bank less of a
political football.
3. Several banks have staff representatives on the supervisory board, often with
trade union backing. Some have representatives of trade associations, partner
banks or other stakeholders. Others have entirely public membership.

While learning from international best practice, Scotland can go further and pioneer
new, more inclusive and accountable governance arrangements. The SNIB’s governance
structures could include representation of not only elected politicians and banking
professionals but, for example, community representatives and SME groups, perhaps on
a rotating basis. Ultimately the aim should be that governance is not dominated by any
single interest group but balances input from a wide range of stakeholders from across
the spectrum of Scottish society.

It is important that the SNIB is organisationally independent to ensure that the bank
makes sound, long-term lending decisions, free of day-to-day political interference.
Although the government would be the SNIB’s shareholder and would set its strategic
mandate, it would have no influence over lending decisions or how the SNIB manages
its funds. In order to ensure this is achieved in practice, it is proposed that the following
governance structures are put in place:
Table 2: Proposed governance structure of the SNIB

<table>
<thead>
<tr>
<th>Membership</th>
<th>Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>Board of Governors</td>
<td>Setting the strategic mandate, appointing senior executives, assessing the performance of the SNIB but explicitly prohibited from interfering with day-to-day management and banking decisions. This board would meet infrequently—probably only annually and would have certain legal duties to perform, such as approving the annual report and accounts.</td>
</tr>
<tr>
<td>Supervisory Board</td>
<td>Ensuring that the SNIB was operating in accordance with the strategic mandate set by the board of governors. Strictly a supervisory role and explicitly prohibited from interfering with day-to-day management and banking decisions. This board would meet more regularly, perhaps quarterly, to oversee and challenge the SNIB’s executive board.</td>
</tr>
<tr>
<td>Executive board</td>
<td>Running day-to-day management of the SNIB and responsible for making all banking decisions. The chief executive would regularly report to the Supervisory Board.</td>
</tr>
<tr>
<td>Advisory Council</td>
<td>Periodically assessing the existing strategic mandate of the SNIB and making recommendations to the board of governors about changes to them. This council would meet perhaps every two or three years, and could also make recommendations about changing the SNIB’s capitalisation and leverage ratio.</td>
</tr>
<tr>
<td>Technical advisory groups</td>
<td>Ad-hoc expert groups established to give specialist advice on technical matters e.g. on science, economy, environment.</td>
</tr>
</tbody>
</table>

Membership categories include:
- Government ministers, external experts appointed by the First Minister, staff representatives with trade union backing
- Cross-party group of MSPs
- SNIB senior management, representation from community stakeholders and business groups, staff representatives with trade union backing
- Government ministers, MSPs, senior civil servants, representation from community stakeholders, business groups and local authorities
- Academics and industry specialists
5.3 MEASURING SUCCESS
As well as a clear and stable mandate, a SNIB would also need a clear and effective performance indicator framework. Indicators and targets have been controversial in some parts of the public sector, usually where they cut across a well-established professional ethic (as in education and health care). But they will be essential for the SNIB. Without a mandate to maximise profits, targets are needed to prevent managers simply maximising volume or being influenced or corrupted by their own or more powerful interests\(^5\). Moreover, a SNIB would need to be able to monitor its performance accurately to allow it to improve services to customers\(^6\).

It is not within the scope of this report to outline a specific performance indicator framework, however evidence suggests that indicators should be strongly aligned with the bank’s mandate and social, economic and environmental goals, cover both the short and long term and be focused mainly on outcomes rather than outputs\(^7\).
6. FINANCIAL ISSUES

As noted earlier, the fundamental role of a SNIB would be to leverage relatively small amounts of public capital into a significant source of strategic and long-term finance that can be channelled into areas of the economy in most need. In this section, we outline how a SNIB would do this sustainably at low cost.

6.1 CAPITALISATION AND START-UP COSTS

As with all banks a SNIB would need to start out with an amount of its own funds, or ‘capital’. Having a strong capital base is important to ensure that any losses can be absorbed and that the bank is protected from insolvency. A bank with insufficient capital can easily go bust if it suffers large losses.

This initial injection of capital would need to come from the Scottish Government, and lessons in this regard can be drawn from the capitalisation models of the European Investment Bank and the Nordic Investment Bank. In both of these models, the member governments ‘subscribe’ (guarantee) an amount to the bank, which underwrites the banks activities, but the amount of capital paid-in to the bank is significantly smaller. For example, only 6.82% of the Nordic Investment Bank’s €6,141.9 million subscribed capital stock is physically paid in – the remainder of the subscribed capital consists of callable capital, which is subject to call if the Board of Directors deems it necessary. The bank is then able to raise 2.5 times the amount subscribed through borrowing which is used to finance its investments.

Following this model, a SNIB could be adequately capitalised without an unduly large cash draw on the Scottish Government’s budget while also ensuring that it starts with a capital base big enough to make a serious contribution to the Scottish economy. The Scottish Government’s capital budget is set to grow from just under £3 billion in 2016-17 to £3.2 billion by 2019-20. In addition, under the Scotland Act 2016 it now has powers to borrow up to 15% of the total capital budget (including Financial Transactions). In total, £3.63 billion will be available for capital spending in 2016-17.

As outlined in Banking for the Common Good, if only £225m of the Scottish Government’s capital budget was set aside as ‘paid-in’ capital for the SNIB but that accumulated figure over six years was ‘subscribed’ (that is, not physically paid in but subject to call if the Board deems it necessary), the bank would have a total subscribed capital of £1.35 billion. As with the European Investment Bank and the Nordic Investment Bank that subscribed figure could then be leveraged through borrowing on capital markets at a ratio of 1:2.5, raising £3.37 billion of available finance for SNIB loans from year one. This would grow each year as profits were retained and the SNIB’s capital base increased,
thereby increasing the SNIB’s borrowing and lending capacity. This would be a formidable financial institution in the context of the Scottish economy and comparable in scale to other national investment banks countries such as the German KfW.

Table 3: Capitalisation of a SNIB

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid in capital</td>
<td>£225m</td>
</tr>
<tr>
<td>Subscribed capital</td>
<td>£1,350m</td>
</tr>
<tr>
<td>Maximum borrowing for investment</td>
<td>£3,375m</td>
</tr>
<tr>
<td>Leverage</td>
<td>2.5x</td>
</tr>
</tbody>
</table>

Clearly, if the initial injection of paid-in capital was sourced from the Scottish Government’s budget, this money could not be spent on other priorities. However, our suggested paid-in capital injection amounts to only 6.5% of the Scottish Government’s capital budget, and because this would be leveraged at a ratio of 1:2.5 and lent out many times over, using the capital budget in this way would have a much larger impact on the Scottish economy than if the Government simply spent it directly. Moreover, under the Budget Exchange Mechanism agreed with HM Treasury there is flexibility in how the capital budget is spent over time, and a SNIB would more than pay for itself over the medium-term. As will be shown in section 6.3, by providing a low cost alternative to expensive public private partnership schemes a SNIB would generate significant savings to the public finances which would more than offset the initial cost of capitalising the bank.

Aside from initial capitalisation there would also be other initial start-up costs associated with establishing a sizeable new public entity. While these costs will ultimately depend on the specific organisational arrangements, a rough estimate can be arrived at by looking at the set-up costs of similar institutions. For example, as part of a feasibility study of the UK Green Investment Bank (GIB) the consultancy firms Vivid Economics and McKinsey & Co estimated initial start-up costs in the range of £11 million. While this figure seems high in the context of a SNIB, we consider that it can reasonably be used as an upper bound approximation.
6.2 FUNDING

Once capitalised the SNIB would use its capital base to raise additional funds to channel into the Scottish economy. As discussed above, it is suggested that borrowing is capped at 2.5 times the amount of subscribed capital, consistent with the European Investment Bank and the Nordic Investment Bank.

The most effective way to borrow funds on capital markets would be for the SNIB to issue bonds. These bonds would not have an explicit government guarantee but they would be likely to attract a high credit rating due to the SNIB’s public ownership, robust governance and high quality mix of assets (loans) on its books\(^6\). Bonds issued by the European Investment Bank similarly have no government guarantee but have always had a AAA rating.

In making the case for a British Investment Bank (BIB) that would raise capital through bonds, Robert Skidelsky (2011) states\(^9\):

> “BIB bonds would not be covered by an explicit government guarantee; instead it is the public ownership and the quality of the credit portfolio that would vouch for the institution’s credibility. In an economy crippled by uncertainty and with substantial pools of un-invested savings, BIB bonds would offer an attractive option to investors: they would be less risky than corporate bonds while offering a yield higher than that of government gilts.”

There is no reason why this would not also be the case for a SNIB. This would make SNIB bonds attractive to pension and insurance funds and to overseas investors. In particular, SNIB bonds could be an attractive investment for the Scottish local government pension scheme, which currently manages assets worth £28 billion\(^9\). At present very little of the local government pension scheme is invested in local infrastructure – instead almost half is invested in overseas equity and another quarter in UK equities\(^1\). A recent study found that Scottish local government pensions had an estimated £1.665 million invested in fossil fuel companies\(^2\).

SNIB bonds would provide long-term and relatively low-risk investment opportunities for local government pension schemes to rival government and other safe bond holdings. Recent attempts in Scotland and the UK to try and encourage local government pension funds to invest more in infrastructure\(^3,4\) have been largely unsuccessful due to the perceived complexity of investing directly in infrastructure and concerns around upholding fiduciary duty to scheme members\(^5\). In contrast, the low risk, stable and fixed income features of SNIB bonds mean that they would likely be perceived as a more attractive way for pension funds to invest in infrastructure.
While a SNIB would require initial government capitalisation and a period of fundraising on capital markets to get started, over time the frequency with which it issues debt may be lessened. As discussed in section 4, the SNIB would be profit-making, in support of its customers, but would retain profits and pass them on to its customers in the form of a lower cost of finance.

Provided the SNIB made sound investments which generated a reasonable return, is staffed by experts with sufficient expertise and is equipped with strong local and sectoral intelligence, there is no reason why the SNIB could not in time become largely self-financing. This is the case with the Brazilian Development Bank or BNDES whose funds are derived from returns generated over many years, meaning that it is a de facto self-financing institution76.

6.3 ECONOMIC BENEFITS
A SNIB could have a transformative impact on Scotland’s economy. Firstly, by providing a low cost source of finance it would bring significant benefits to the public finances compared with using expensive public private partnership schemes. As an example, figure 5 shows the total cumulative cost to the public purse of all the projects that have been financed or are planned under PFI and NPD in Scotland. It also shows an estimate of what these projects would have cost had they been financed through a SNIB instead of through the PFI/NPD model. The example assumes conservatively that a SNIB could have borrowed at a 3% premium on 10 year UK gilts, ranging from 10% in 1997-98 to 4.9% in 2015-16. Other similar national investment banks are able to borrow at much lower interest rates than this thanks to their AAA credit rating.

In total there have been over £8 billion worth of projects financed through PFI or NPD in Scotland since 1998-98, with the majority (around £5.7 billion) done through the PFI model. Under the current payment arrangements these will cost the public purse a cumulative total of nearly £40 billion by 2047-48 – five times the original capital outlay. If instead these projects had been financed by a SNIB on the terms outlined above, they would only have cost £13 billion and would have been fully paid off by 2027-28 – a total saving of £26 billion compared with PFI/NPD.
Figure 5: Cumulative cost of PFI/NPD versus SNIB financing

Source: Authors calculations using data from the Scottish Government\textsuperscript{27} and Bank of England\textsuperscript{28}.  
Note: Figures are in nominal prices.

Moreover, by facilitating the construction of new infrastructure and helping SMEs expand, a SNIB would help create new jobs and boost employment in the private sector. The Scottish Government estimates that every £100 million in capital investment supports 1,400 jobs across Scotland\textsuperscript{79}, which suggests that a SNIB could support the creation of over 50,000 new jobs across Scotland within just a few years of being established.
7. IMPLEMENTATION ISSUES

This section covers other practical issues which would need to be addressed in setting up a SNIB such as sector classification, the interaction with national accounting rules and the Scottish budgeting process, compliance with EU State Aid rules and regulatory considerations.

7.1 SECTOR CLASSIFICATION

When the government establishes a new body, privatises or nationalises an existing one, or enters into a new partnership or joint venture with the private sector, the resultant body must be classified for National Accounts purposes to either the public or private sector. The body’s assets and liabilities from its investments or operations will be accounted for according to this classification.

The Office for National Statistics (ONS), as the UK’s independent national statistics body, decides the treatment in the National Accounts by applying the European System of Accounts standards (‘ESA95’) and referring to a case history of previous classification decisions. The ONS is clear that the key factor in determining whether a body is a public or private sector is where control over the organisation lies, rather than “ownership” or whether or not the entity is financed from public funds80. The international guidance defines control as the ability to determine corporate policy, appoint directors and have the majority voting interest, among other things. If a body is deemed to be controlled by government or a public corporation, then it will be classified as in the public sector. If not, then it will be classified as in the private sector.

Staff at the ONS have advised that if a SNIB was established under the governance arrangements proposed in this paper then it would likely be classified as a public financial corporation.

7.2 UK NATIONAL ACCOUNTING RULES

Under normal circumstances, a body classified as a public sector corporation will have an impact on Public Sector Finance statistics and the UK Government’s fiscal targets. This is because in the UK the main measure of public debt is ‘public sector net debt’, which is defined as public sector financial liabilities (for loans, deposits, currency and debt securities) less liquid assets. According to the ONS definition, the public sector comprises central government, local government and public corporations. While the UK government targets total debt across the whole public sector, this is not standard practice internationally. Many countries (as well as the EU Maastricht Treaty and the OECD) monitor and target the general government measure, which includes both
central and local government but excludes public corporations. In these countries the liabilities of public sector corporations are not included in measures of government debt. This is particularly relevant for countries where there is significant government support for the banking sector, such as Germany.

In 2015 Germany’s general government gross debt stood at 71% of GDP\(^8\). However, data on the so-called “contingent liabilities” of EU Member States is available from Eurostat and which covers liabilities not included in the general government measure such as government guarantees, public-private partnerships and government controlled entities classified as outside general government (public corporations)\(^9\). When liabilities of public corporations are added to the general government gross debt for Germany (as they are in the UK measure) the total amounts to 186% of GDP – the highest in the EU. This is largely attributable to the scale of the German public banking sector which includes the KfW at the federal level, the state banks (Landesbanken) and the municipal savings banks (Sparkassen)\(^3\).

This illustrates the somewhat unusual and arbitrary nature of the UK’s approach to measuring public finances, and a logical case can be made for aligning the UK’s measurement of debt to the general government measure used in other countries. The case for doing so is strong: there is a qualitative difference between general government borrowing because spending exceeds tax revenues, and a SNIB raising funds in capital markets to finance infrastructure projects that will generate a stream of income in the future\(^4\).

If this were to happen, as a largely self-financing public institution the SNIB’s assets and liabilities would not count towards the general government debt. The only impact the SNIB would likely have on general government debt measures would be the initial capital injection required to start it up (which as discussed in section 6.1 would come from the Scottish Government’s budget).

It is also worth noting that following the bailout of the banking system in 2008 the UK government changed its main measure of public debt to ensure that the liabilities of the publicly owned banks such as Lloyds Banking Group and the Royal Bank of Scotland did not affect the public sector net debt. Currently the main measure of public debt in the UK is ‘Public sector net debt (excluding public sector banks)’. This change was not required under international accounting principles and demonstrates that there is flexibility in the way the performance of management of public finances is assessed. In the likelihood that the UK Government does not switch to the general government debt measure any time soon, it can reasonably be expected that, as a public sector bank, the
SNIB’s liabilities would be excluded from the measure of public sector net debt as currently happens with RBS.

7.3 SCOTTISH BUDGETARY RULES
The financial relationships between the UK Government and the Scottish Government are set out in the Statement of Funding Policy and the Memorandum of Understanding and Supplementary Agreements between the devolved administrations and the UK Government. If the SNIB was classified as a public sector corporation then under these rules it is possible that some or all of the SNIB’s lending would score against either the Scottish Government’s Capital Departmental Expenditure Limit (CDEL) or its capital borrowing limit. Under such a scenario a SNIB would not be able to raise additional funding to finance lending beyond that which is allowed in the current CDEL and borrowing limits unless budgets were cut elsewhere, which would severely restrict the ability of the SNIB to meet its mandate.

It is therefore likely that the Scottish Government would need to request changes to budgeting rules to ensure that the lending activities of the SNIB do not score against departmental expenditure limits or draw down from the Scottish Government’s capital borrowing limit. Changes to these rules are not without precedent, as the recent example of the Scottish Government’s announcement of a new Scottish Growth Scheme demonstrates.

When the First Minister announced the launch of the scheme, which will provide up to £500 million of government guarantees and loans to SMEs with significant growth or export potential, it was recognised that changes to the budgeting rules would need to be agreed with HM Treasury to ensure that the scheme does not show up on the Scottish Government’s balance sheet and divert money from public services. The establishment of a SNIB would likely require similar discussions with HM Treasury.

The proposal for a SNIB can be viewed as a much more ambitious and effective version of the Scottish Growth Scheme. Whereas the time horizon of the Scottish Growth Scheme is limited to the initial £500 million of funding, if this money was instead put towards a capitalising a SNIB the £500 million could be leveraged at a ratio of 1:2.5 and lent out many times over.

7.4 EU STATE AID RULES
In light of the UK’s vote to leave the European Union (EU) the future of Scotland’s relationship with the EU is unclear. However, as long as Scotland remains part of the European Union, the Scottish Government would likely have to gain state aid approval from the European Commission before it could establish a SNIB. The EU has strict state
aid rules that prevent governments from providing financial support that could distort competition and affect trade by favouring certain undertakings or the production of certain goods. Support has to pass four tests for it to count as state aid:

1. It has to be granted by the state or through state resources
2. It has to confer a selective advantage to an undertaking – i.e. some undertakings get it and some do not
3. It has to distort or have the potential to distort competition – i.e. strengthen the beneficiary relative to competitors
4. It has to affect trade between member states – in practice, to affect any market where the goods or services are tradable between member states.

Where the Commission finds aid to be illegal, it is under a legal obligation to seek the recovery of the aid from the recipient, plus interest, and competitors may also seek legal action for damages.

However, there are a number of exemptions which enable EU states to provide financial support, mainly in relation to services which the market fails to provide properly. These include financing for SMEs, innovation and environmental protection purposes. In order to ensure state aid compliance, the SNIB should aim to complement rather than compete with commercial banks by providing additionality: i.e. showing that it is providing finance in areas that are currently being underserved by the private sector. This should be achieved by focusing the SNIB’s mandate on the three core activities outlined in section 4.

Whether or not a SNIB would have to comply with EU state aid rules ultimately depends on the ongoing arrangements that are negotiated between the UK Government and the EU. Of particular importance is whether the UK retains full access to the EU single market. However, in the event that state aid rules continue to apply, it is recommended that consultations with the European Commission commence at a very early stage in the process. Experience from setting up the Green Investment Bank suggests that gaining state aid approval from the European Commission can be a lengthy – although by no means impossible – process.

7.5 REGULATORY CONSIDERATIONS
As a bank the SNIB would need to be authorised and regulated by the Financial Conduct Authority and the Prudential Regulation Authority and subject to international regulations on capital, liquidity, leverage and risk management requirements. These are currently formulated by the Basel Committee on Banking Supervision (BCBS), based in
Basel, Switzerland, and implemented at European level through Directives or directly-applicable regulations.

The proposal to cap the SNIB’s leverage at 2.5 times the amount of subscribed capital should ensure that there would be no problem complying with these regulations.
8. CONCLUSION

Meeting the challenges of the twenty-first century requires bold and ambitious plans for financing and directing investment in a smart, inclusive and sustainable direction. From climate and demographic change to economic inequality and innovation, Scotland’s long-term prosperity depends on having mechanisms in place to direct sufficient levels of investment to the areas of the economy most in need. However, with public budgets in decline, economic uncertainty increasing and a banking sector still focused on short-term shareholder returns, Scotland’s longstanding problem of underinvestment looks set to continue. As a result, the need for fresh thinking on investment is greater than ever.

We believe that Scotland’s devolved powers present an opportunity to chart a different course to that being pursued in the rest of the UK. In this paper we have set out how establishing a Scottish National Investment Bank would be the first step towards creating a new ecosystem of national and local banking institutions, democratically owned, controlled and accountable, investing sustainably in local communities. By providing long-term “patient” capital to areas of the economy most in need, a Scottish National Investment Bank would help narrow the gap in Scotland’s productivity performance, diversify and expand the business base and speed up the transition to a low carbon economy, whilst also supporting the creation of over 50,000 new jobs and generating billions of savings for the public purse.

In 2013 the Scottish Government set out a strategy to “fully repair...the appropriate relationship between the banks and the society in which they operate”, insisting “where the Scottish Government can act, it will”. With the new Scottish Parliament in its formative stages, we believe that the time is right for the Scottish Government to examine these proposals in greater depth. By positioning Scotland at the forefront of innovative banking reform that learns from best practice around the world, it would begin the process of reasserting the country’s once proud banking tradition.
ENDNOTES


29 Martin, A. & Ryan-Collins, J. (April 2016). *The financialisation of UK homes*. Retrieved from: [http://b.3cdn.net/nefoundation/496c07a5b30026d43a_d1m6i26iy.pdf](http://b.3cdn.net/nefoundation/496c07a5b30026d43a_d1m6i26iy.pdf)


32 Ibid. p.17.


42 Ibid. p.134


45 Ibid. p.18


61 Ibid. p.54.

62 Ibid. p.22


