Scottish National Investment Bank

Introduction

Common Weal has been arguing for a Scottish National Investment Bank for a number of years now and has produced a series of reports on the subject. We are therefore very enthusiastic about this development and therefore very much welcome the opportunity to provide suggestions on how the bank should be set up. This submission is drawn from our work on the bank proposal but also from policy work we have done on industrial policy, regional economic development, support of small (particularly manufacturing) businesses, building national infrastructure, housing and energy.

We have structured this submission according to the structure of the consultation document but have opted not to use the ‘multiple choice’ question approach, instead narratively explaining what we believe needs to be achieved under each question. We hope this is seen as a supportive and constructive contribution to this project.

What is the purpose of SNIB and what should it do?

A Scottish National Investment Bank (SNIB) should in part be seen as a means of providing finance in circumstances where the market is not doing so effectively. However, this is only part of the role; it should not be seen as a ‘deficit model’ designed only to fill gaps in the existing system. Rather, the role of the bank should be to make investments in enterprise and infrastructure in Scotland which works towards a ‘public good’ intervention in the economy as a whole. While it should not see itself as in direct competition with existing private banks, it may well wish to invest in some of the kinds of enterprises that would currently get finance from private banks if SNIB is able to provide lending criteria which private banks are unable to. Lending differently rather than just lending to different people should be part of the remit of the bank.

The bank must first andforemost be a bank. It is not a grant-giving body or a venture capital fund. To enable the bank to be capitalised and maintain confidence from all parties, each lending decision must be made on the basis of a sound assessment of the business case. It must work on the assumption of generating stable and reliable returns on investment. And it must be demand-led, with lending being driven by enterprises and initiatives which already have momentum and are seeking finance. While it is perfectly reasonable for the bank to take actions it believes may stimulate demand, it should not be aggressively selling products to those who do not approach it. And it should not be a ‘supply model’, operating to any kind of government target on what it should lend to or how much it should be lending. The system must be successful on the basis that SNIB provides a function which enterprises working in our market economy want to access. It should do this in a public good manner; but as a development bank, not as an investment fund.

The success and impact of the bank must be considered to be the sum of all its lending. While ‘number of individual businesses supported’ will of course be an important metric, as a public good bank it must be working towards broad public good outcomes. It must therefore expect to work at a substantial scale and that its entire portfolio of lending is capable of creating economic change at the system level and not just at an individual business level.

The bank should not be working to external economic development metrics but must be measured on the basis of the success of each investment (achieving a successful return on that investment) and also in the extent to which it is working towards its mission. It is the mission-driven nature of the bank which should set it apart from the banking sector as a whole. That mission should steer individual lending decisions. Therefore each lending decision should be assessed against the ‘public good’ mission set out for the bank.
The core mission of the bank will have elements both of continuity and change. The bank should be constituted such that the range of its mission elements is clear and unchanging. However, it should be clearly understood that interpreting what each of this mission elements mean in a specific context will change. For example, one of the criteria should be that the bank has an interest in influencing the overall balance of the economy such that it is as sustainable and effective as possible. However, that general mission will change. At some points it might be that there is a need to rebalance away from (say) retail and towards manufacturing or away from private ownership of housing to public rental of housing. However, if the bank is successful in encouraging rebalancing, the need for that rebalancing will decline. Meanwhile other economic problems (perhaps underinvestment in new technology or a trade deficit) may arise in the future and may become core aspects of bank strategy.

There should therefore be a two-layered mission for the bank. One layer is constant and outlines its broad purpose. The second interprets that purpose for a given period. For example, the constitution of the bank may specify that one of its key roles is to encourage economic diversification, and that may be a permanent role. But then some form of regularly revised development plan would interpret what forms that diversification might take in the economy as it is now. An example of that might be that for now, diversification into low carbon is the primary area which might be considered a priority but that in years to come adaptation to the use of AI might become the priority. The bank should therefore have a strong set of underpinning principles and a regularly updated development plan, perhaps every three or five years. The Scottish Government should submit letters of guidance at regular intervals to indicate what the Government believes should be priorities for a given period. A policy committee of the bank would then take this advice, as well as advice from other stakeholder groups and also economists and other observers, to develop its three or five year plans.

But the bank remains a bank. The purpose of the mission is not to create continually ring-fenced new funds targeted at specific purposes (this is the role of an economic development agency) nor to create funding streams for forms of economic activity devised by the bank itself and seeking to ‘incentivise’ enterprises to deliver the banks priorities. Rather, the mission is an assessment tool for what to lend, how to lend and who to lend to.

The following is an initial set of suggestions of the permanent range of bank mission elements which should be written into its constitution. Each decision would then be measured against the likelihood that it will:

- Promote the long term sustainability of enterprise in the Scottish economy, emphasising long-term borrowing which offers security and partnership working to maximise the longevity of relationships
- Encourage diversity of ownership model (private company, social enterprise, mutual, cooperative, community ownership, publicly owned), promote domestic ownership of enterprise (more enterprises owned in Scotland) and ‘anchor’ enterprises to prevent them being bought up and jobs exported
- Rebalance the economy, between sectors of the economy (for example, between retail and manufacturing) and by reducing negative externalities of specific business activities on the economy as a whole (for example, between rising house prices and the cost of renting, or between speculative financial activity and overall economic stability).
- Promote public good outcomes from economic activity such as reducing poverty, improving equality, reducing gender pay inequality, improving environmental performance and so on.
- Improve quality and level of development of industry including rates of innovation, stage of technological development and level and nature of productivity
- Influence balance of trade by promoting exports and ensuring strong domestic production for domestic consumption to reduce reliance on imports
- Affect differential rates of regional development, supporting and prioritising growth in low-growth regions
- Achieve reasonable returns on investment, but never be profit-maximising, particularly at the expense of the missions outlined
- Improve national public infrastructure through partnership working with the public sector

Who should the bank lend to?

The bank should have no restriction on who it lends to subject to meeting the mission of the bank. It should lend to early stage start-ups, established and growing businesses, the public sector to build infrastructure – any form of lending which meets the mission and which is assessed to be a good investment decision in relationship to returns. It should be demand-led and consider any request for lending it receives, and should promote itself to enterprises on the basis of being open to all. In the long term the development of a network of ‘local development banks’ pursuing the same sort of mission but on a smaller and more local scale would be a more responsive structure and would enable the SNIB to concentrate on larger and national level borrowing.

Is lending to the public-sector important?

According to figures from Eurostat the UK has among the lowest rates of public investment in Europe, both as a percentage of GDP and a percentage of government expenditure. The Scottish Government currently has few levers to overcome this weakness, with a capital budget that has shrunk since 2010 from 3.4 to 1.4 per cent of GDP, and borrowing powers restricted to just 15 per cent of the capital budget.
Therefore the need to increase annual public investment in the Scottish economy is evident. The bank should treat the public sector, including Scottish Government and local authorities, as a client like any other, judging lending decisions against the same mission-driven criteria. The interest rate charged on public institutions should reflect the fact that they are historically a very safe investment, and therefore it would be expected that rates charged would be lower than to private institutions.

The importance of lending to the public-sector is due to the constraints on Scottish Government borrowing set by Treasury rules and the rates charged by the Public Works Loan Board to local authorities, which are one per cent above UK Guilt rates on all standard rate loans.

PWLB loans to local authorities tend not to be based on the specific nature of what the money is going to be used for by local authorities. A loan could equally be used to pay for a new road or for council housing. Yet the nature of these assets are fundamentally different, with different income streams over a different life-time. The bank, as well as providing rates cheaper than PWLB, could provide loans which are more reflective of the specific investment requirements. For instance, council housing can have at least a 60 year life cycle, and therefore loans could be devised over the full life-time of the asset.

While the Scottish Government could not borrow from the bank directly above its already restricted capital borrowing limits, it could work with one or multiple local authorities to combine investment projects, with the Scottish Government providing co-ordination and logistical support to regional projects, with local authorities being the principle lenders of such projects. Common Weal has described this model as a public-public partnership and developed the proposal in more detail in a paper earlier this year (See Cairns, Cooper, Watterson, Wray, 2017).

**How should the bank be capitalised?**

Unlike the presently existing Scottish Investment Bank, which operates a fund for investment run by Scottish Enterprise, SNIB should be a bank with full powers to issue credit. This is vital if the bank is going to be capitalised in such a way that it can make a serious impact on the development of the Scottish economy as a whole. Credit creation should be based on a leverage ratio which is much safer than commercial banks to ensure the bank is well capitalised. A very cautious leverage ratio would be 2.5:1.

Common Weal papers by Bone (2016) and Macfarlane (2016) have both proposed a starting point for the bank’s capital base being a small annual percentage of the Scottish Government’s capital budget. This could be done through a similar method to the European Investment Bank, where the Scottish Government commits to a subscribed capital figure over a number of years but pays in an annual sum. The bank could then leverage on this subscribed figure.

As Bone (2016) has pointed out, “If only £225m [5.8 per cent] of the Scottish Government’s capital budget was set aside as ‘paid-in’ capital for [the bank] for six years and that accumulated figure was ‘subscribed’, the bank would have a total subscribed capital of £1.35bn. That subscribed figure could then (like the NIB and EIB) be leveraged at a ratio of 1:2.5, raising £3.37bn of available capital for SNIB loans from year one.” A capital base of £3.37bn for the bank would therefore be (proportionately speaking) of similar size to the German kreditanstalt für Wiederaufbau (KfW).

From this starting point, the bank could then establish a bond and would likely be an attractive option for private investors, with public institutions considered to be a very safe investment. Specifically, public pension funds in Scotland would see a national bank as a very reliable source for investment, and the Scottish Government could work to encourage pension fund managers to take this approach. Common Weal co-authored a paper with Friends of the Earth Scotland and Unison Scotland earlier this year on the potential for financing renewables investment from Scottish pension funds (2017).

The importance of the bank being a bank, and therefore issuing credit (new money), is that it allows for a much higher level of investment than would otherwise be the case from, for instance, a government fund, which would therefore make an investment from the Scottish Government into the capital base of the bank desirable for the public as a whole, as total investment would then be scaled up through leveraging.

**What are international examples of best practice?**

The following are examples from Germany of how national and local public banks can work in combination and a best-practise model of a public development bank.

A) National and local banks in combination – KfW and Sparkassen in Germany

Scotland and the UK more generally is unusual in having almost no local or regional banking sector, with 97 per cent of the sector national banks compared to 66 per cent in the US and 33 per cent in Germany. In Germany, the ‘Sparkassen’ banks are 431 local public savings banks with eight regional banks (‘Landesbanken’) which are owned by the Sparkassen and act as financial clearing houses. The Sparkassen have a strict remit to only lend in their local area.

The Sparkassen works with the German national investment bank, KfW, which makes loans via the Sparkassen and small co-operative banks due to their local knowledge. The Sparkassen provided 45 per cent of long-term business lending in 2012, compared to 20 per cent from commercial banks. The Sparkassen have increased their lending since the financial crash, while lending from commercial banks has declined, showing the benefits of financially stable local
banks which are capable of spending counter-cyclically. While Germany is a considerably bigger country than Scotland, a model of a national investment bank part-owned by local authorities and/or a national investment bank working in partnership with locally routed savings banks like the KfW and Sparkassen could prove fruitful.

B) A public development bank model – KfW

KfW presents a model for a public development bank in Europe that could be followed in terms of its structure, mandate and the sort of investment portfolio that could be pursued.

KfW is Germany’s economic development bank and is the fifth biggest capital issuer in Europe after the German, UK, French and Italian governments, at 2.2 - 2.6 per cent of GDP. It is a public-sector bank but its balance sheet does not count on German national debt and deficit figures. KfW raises 90 per cent of its finance through bonds which are guaranteed by government, allowing the bank to borrow at low rates of interest and thus offer cheaper lending rates than the commercial banking sector.

The mandate of KfW is “to sustainably improve the economic, social and ecological condition of people’s lives”. In November 2017, KfW published an update on its investments for the year: it had invested €54.7bn, of which €41.1bn went towards domestic production, with an income of just over €1bn. Of that total investment, €7.9bn went towards SMEs and start-ups, €1bn towards innovation, €8.5bn towards the environment which includes renewable energy and energy efficiency programmes, €15.5bn for housing (€11.1bn of which was the Energy Efficiency Construction and Renovation programme), €2.9bn for public infrastructure financing and €1.6bn for education and social affairs. This is the sort of investment portfolio SNIB could mirror. The magazine Global Finance rated KfW as the safest bank in the world in 2015.

Should the bank support regional development?

Supporting regional development should be a mission of the bank. However, we must also learn the lessons from negative experiences of over-centralisation. It is also questionable whether, in the long term, a bank of the scale of SNIB should be in a direct relationship with the kind of small and sometimes micro enterprises which may be the development priority in some regions. Common Weal has proposed that in time the SNIB should coordinate a network of local development banks. Each of these would be mirroring the mission-driven function of SNIB itself but in a regional/local development context with greater local knowledge.

How involved should the bank be with borrowers?

There is a fairly large range of forms of lending in which the bank could engage and each might result in a different kind of relationship between borrower and lender. At one end is a straight loan model with fixed repayment schedule. This may well suit some forms of enterprise as it is a steady and predictable model. At the other end is equity purchase where the lender takes a share of equity in the enterprise and potentially takes a seat on the board of that enterprise, becoming a key internal stakeholder. For some enterprises this may be a very welcome model, providing close long-term supportive relationships between the bank and the enterprise (the bank would in this model be able to offer ongoing development support). This could also be to the advantage of the public-sector as a whole, anchoring businesses with long-term potential in the Scottish economy (limiting or prohibiting the sale of the enterprise to overseas ownership as a condition of taking an equity stake could be considered).

In between are many options, not all of which will be explored here. As an example, one option is repayment schedules tied to medium-term economic performance (the sum loaned is repaid on the basis that the enterprise is growing at a rate which allows it to repay the loan, with slower repayments during periods of slower growth and much faster repayments when growth is rapid). The bank should be open to use as many of these modes of lending as appears to be relevant and helpful to borrowers and effective in delivering public good outcomes. Each lending decision, once assessed against mission, should then be assessed (in discussion with the enterprise itself of course) on which mode of lending is best suited to the business plan set out by the enterprise.

If for example, a National Housing Company wanted to borrow against future rent to build a large volume of new high-quality housing, a loan model where repayment takes place over say 30-40 years should be possible, but since housing is a reliable and profitable investment the overall returns over that period might be high.

Flexibility should be shaped not primarily to the immediate interests of the bank (subject to the viability of the loan and the likelihood of a return) but to the interests of the borrower. Unlike a commercial bank, the longevity of the enterprise should be the priority of the bank and lending should be done in such a way that it is in the interests of both the bank and the enterprise to work together towards that long term aim.

How should the bank be governed?

This is crucial. First of all, the bank must be a bank, not a development fund or another form of fixed-pot allocation.
It must be able to borrow from investors and use that capital to pursue its mission on a demand-led (rather than resource-capped) form, recycling profits into the business model to grow its ability to support enterprises. It will also be unable to fulfil its public good mission if its ability to grow and adapt is severely limited by an annual budget allocated by politicians. So it must be able to make borrowing and lending decisions and set and manage a business plan autonomously and independently from government.

However, the bank is very unlikely to be successful in its mission if it is not a 'public' institution. If it is purely private and reliant on any form of for-profit shareholding or other form of equity ownership it will be built to include incentives to do things which are counter to its mission. However, the meaning of 'public' need not mean wholly owned and controlled by government. Indeed, as one of the key missions of the bank should be to promote the longevity of enterprises, that requires the longevity of the bank and the ability of the bank to work to those longer timescales. There is always a risk if there is majority governmental control that an incentive is built in to work to electoral time cycles which may contradict the interests of long-term mission achievement.

There are a number of possible ways to manage this. One is to have the bank legally owned by government but to constitute it in such a way that government is unable to hold majority control. Another is to make it a jointly owned enterprise, perhaps by sharing ownership between central and local government such that no single administration has overall majority ownership. It might even be possible to create other mutual models in which non-governmental actors, such as housing associations or credit unions, have some ownership. Another possibility would be some form of 'trustee ownership'. However Common Weal would oppose this option because it has a poor track record of successfully meeting public need, with the individual perspectives of a group of appointees tending to drive the bank in an increasingly traditional direction. Other more radical options (such as genuine public ownership with every adult citizen in Scotland owning one voting-but-non-transferrable share) could be considered.

So the bank must be constituted and its governance designed to be a proper bank and it must be owned 'publicly' in such a manner that protects its public good mission, but equally as important as this is how it is governed.

Common Weal has proposed a possible governance structure in Macfarlane, 2016. We believe the key is to recognise that the public good role has three 'interest groups' and that effective governance would mean each of these has a balanced voice in the governance arrangements. One group of interest is 'the citizen' who will want the bank to be run reliably and professionally. This means that one third of the governance structure should focus on 'professionalism' and therefore involve finance sector professionals who are able to monitor the technical performance of the bank to ensure it is achieving value for public money and is able to support the public good role. The second is to ensure the public good mission is prioritised. This might be done by having a third of the governance structure populated by people who represent this 'public good' element. That might mean a combination of representatives of government, local government, trade unions and possibly also people with expertise in environmental issues or possibly poverty and equality issues. The final third of the governance structure might best be made up of representatives of borrowers. That would mean enterprises and public bodies who are likely to borrow from the bank.

A tripartite mutual model ensures that the different aspects of bank mission are met. The finance professionals are there to argue for 'good banking', the public good representatives are there to argue for the emphasis on 'doing the right thing', and the borrower representatives are there to argue for the forms of lending which are best able to support and sustain their development. These three interests in balance should be able to ensure the success of the bank both as a bank and as a public intervention in the economy.

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Bibliography


