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Scottish National Investment Bank Bill

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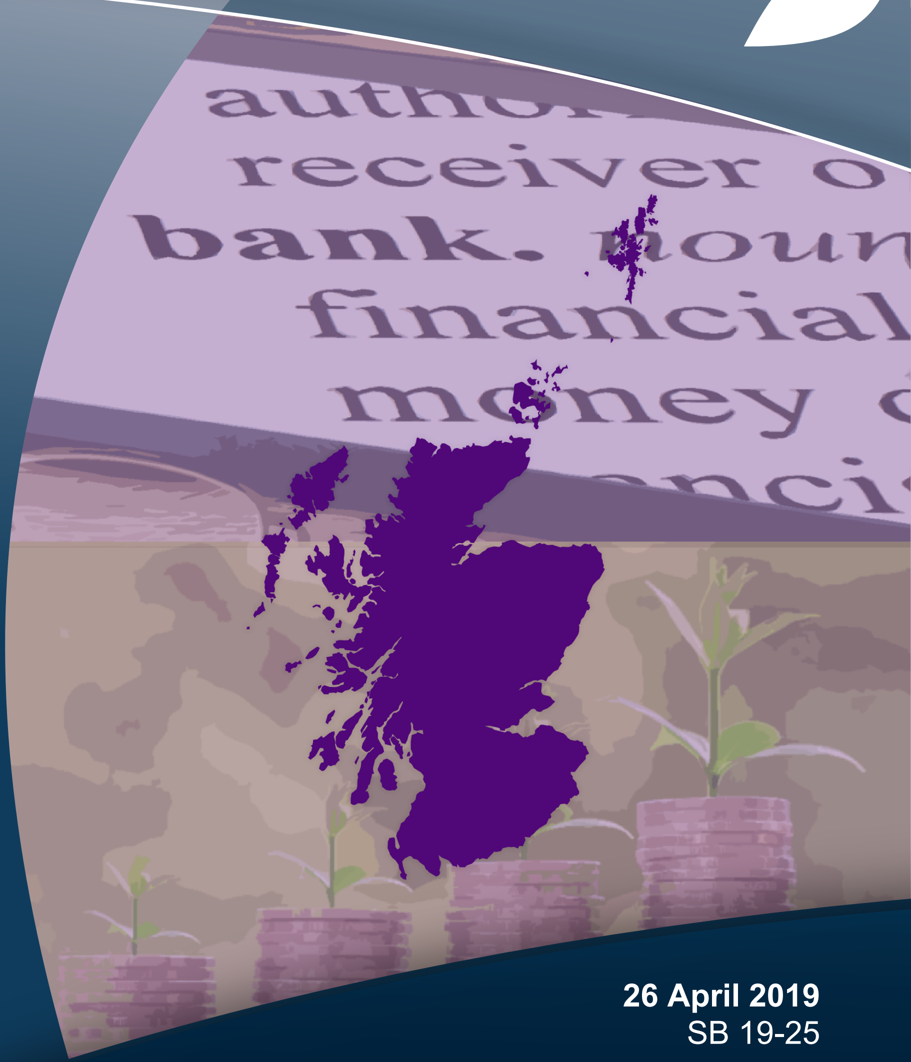

The Scottish National Investment Bank Bill will place a duty on the Scottish Ministers to create the Scottish National Investment Bank as a public limited company and to provide it with its articles of association. The Scottish Government intends the Bank to be operational in 2020, subject to Parliamentary approval of proposals.

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The timeline of the Scottish National Investment Bank starts in 2017 but the idea of a type of development bank for Scotland is not new and goes back to 2013. An Implementation Plan for the Bank was launched in February 2018 and it is intended the Bank will be fully operational in 2020, investing in businesses and communities across Scotland.

National investment banks have experienced something of a renaissance in Europe since the 2007-08 financial crisis. There has been a trend whereby private markets retreated from financing the economy, whilst simultaneously the economy itself became increasingly financialised. This trend resulted in public finance becoming more important for capital investments. Much of the Scottish Government's inspiration for a national investment bank draws on the academic work of Professor Mariana Mazzucato.

The two most important issues in the Scottish economy that the Bank is intended to address is a need for greater long-term investment in small to medium size enterprises (SMEs) and to improve Scotland's relative innovation performance which lags behind comparator countries.

The proposed activities of the Bank go beyond a classic market failure correcting role to include a mission-orientated role to make strategic investments, which focus on solving Scottish societal challenges. Given that current analytical frameworks used by governments to appraise and evaluate policy assume that government interventions are mainly concerned with correcting market failures - it is valid to question from the outset how the Scottish Government will be adapting appraisal, evaluation, and monitoring tools in relation to the Bank.

The Bill

The Scottish National Investment Bank Bill, introduced to the Scottish Parliament on 27 February 2019, will require Scottish Ministers to establish the Bank, and gives them powers to capitalise it. It also makes provision for the purpose, objects, ownership and governance of the Bank.

The Bill describes the relevant powers of the Bank in broad terms but leaves a lot of the detail to the Articles of Association (that is to say the constitution of the Bank as a plc). The Bill does not confer any powers in itself, rather it sets out what the Bank's Articles of Association will have to say about its powers.

What the Bill does do is place a duty on Scottish Ministers to establish the Scottish National Investment Bank, as a public limited company, and gives the necessary powers to Scottish Ministers to capitalise the Bank. Scottish Ministers will also be given the power to set the strategic direction of the Bank by the setting of Missions.

The Bill places a duty on the Scottish Ministers to provide the Bank with its Articles of Association. It also mandates what is to be in the Articles and the circumstances in which certain provisions can be modified. The Bill also makes provision for the annual reporting and performance review (every five years) of the Bank. The Schedule of the Bill makes provision for the application of public bodies legislation to the Bank.

Section 11 of the Bill gives the Scottish Ministers the power to set the direction of the Bank by the setting of strategic missions. These will be set by the sending of a document to the Bank by the Scottish Ministers setting out the socio-economic challenges that the Bank is to seek to address. Scottish Ministers may set, modify and bring missions to an end by the sending of such a document. The document must be made publicly available and be laid before the Scottish Parliament. However, there is no further parliamentary procedure attached to this requirement, such as a parliamentary vote to approve the document. It is intended that the strategic missions set by the Scottish Ministers will complement the Bank's objects.

It should be noted that if the Bank were legally challenged, it would be the Articles of Association that would be interpreted in a court of law and not the principles of primary legislation.

Financial implications

According to the Financial Memorandum total costs to the Scottish Administration will be £2,050 million. This includes:

- £2,000 million for capitalisation over 10 years (2018-28)
- £23 million for the Scottish Government Bank Programme (2018-21)
- £5 million set up costs (2020-21)
- £4 million for the Scottish Government sponsor unit (2020-23)
- £18 million Scottish Government contribution to operating costs (2020-23)

The Bank will need to secure permission from the European Commission to comply with State Aid rules. Particularly, as in some circumstances the Bank may choose to offer products at sub-commercial rates, which may be deemed to be allowable state aid.

For the Bank to be able to reinvest its financial returns, it will need to secure a dispensation from HM Treasury to have the flexibility to manage, retain and carry-forward cash balances over financial year-ends.

The timeframe for establishment of the Bank has meant development work is continuing in earnest during the Bill process. Thus, the Scottish Government has caveated that much of the cost estimates are subject to further refinement and change, as work on the Bank continues.

Introduction

This stage 1 bill briefing examines the Scottish National Investment Bank Bill. This Scottish Government Bill was introduced to the Scottish Parliament on 27 February 2019. It is a Bill for an Act of the Scottish Parliament to require the establishment of the Scottish National Investment Bank and to make further provision in connection with that body. The briefing is divided into three main sections:

1. This briefing examines the legislative timeline to establish the Bank. It then asks the questions - what is a national investment bank and why do we need one in Scotland. Furthermore, it explores how the proposed Bank will operate.

2. The briefing examines the Bill in detail, highlighting key sections of the Bill. Given the mission-orientated approach suggested in the Bill, this briefing has provided a detailed insight into missions and the related economic theory.

3. The financial implications of the Bill are explored in detail, looking at capitalisation levels, operational costs, and set up costs.

It is worth noting that the Bill does not establish the Bank as a statutory body, rather it places the Government under a duty to establish it as a public limited company; which is to be done in the usual way following the rules of the Companies Act 2006. Thus, this is very much an enabling or framework Bill. The Bill describes the setup and operational activity of the Bank in very broad strokes with much of the detail left to the Articles of Association.

Consequently, to understand the vision and wider characteristics of the proposed Bank, this briefing has drawn a lot from the Implementation Plan and the wider suite of supporting documents published by the Scottish Government over the last two years, as referenced in the Bibliography.

A lot of the terminology used in the Implementation Plan and the Bill is, by its nature, technical. We have therefore tried to explain technical language within the briefing, and included a glossary of terms at Annex C to aid understanding and comprehension.

Background and context

Journey to a national investment bank for Scotland

While the timeline of the Scottish National Investment Bank is as set out below, the idea of a business development bank for Scotland is not new and pre-dates 2017. In 2013 the Scottish Government published a 'Sustainable, Responsible Banking' strategy for Scotland, which proposed examining the business case for the creation of a 'Scottish Business Development Bank'. The 2014/15 Programme for Government committed to developing options for a Scottish Business Development Bank described '*as a dedicated Scottish headquartered structure working directly with small and medium enterprises and the financial markets, including banks, to build and grow the required level of high growth businesses that Scotland needs*'. And in early 2016, the Scottish Government stated that *'Scottish Enterprise have been asked to prepare a plan for creating the Business Development Bank services by expanding the remit of SIB and they will report before the end of the Parliamentary session next month.'*

2017

The Scottish Government's Council of Economic Advisers highlighted [1] the important role that national investment banks play in providing long-term investment to support economic growth in many European countries.

On the back of this advice the First Minister, in the Programme for Government 2017 to 2018 [2] , announced plans to establish a Scottish National Investment Bank - with the aim of boosting Scotland's economic performance and realising the Scottish Government's ambitions for the economy by providing patient capital to finance growth. The Programme for Government built on the 2015 Scotland's Economic Strategy setting out an economic approach to establish an '*inclusive, fair, prosperous, innovative country, ready and willing to embrace the future*'.

The Scottish Government commissioned Mr. Benny Higgins (October 2017), former Chief Executive of Tesco Bank, to provide recommendations on the role, remit, governance and capitalisation of the Bank. Alongside the work commissioned from Mr Higgins, a Consultation Paper was issued on 20 October 2017, which invited comments and suggestions from stakeholders on a series of key issues on the creation of a Bank. The Consultation report was published in February 2018.

In the Draft Budget 2018-19 [3] the Scottish Government announced the Building Scotland Fund as a precursor to the Bank.

2018

An Implementation Plan was launched on 28 February 2018 by the First Minister and Mr Higgins. The Plan was developed by Mr Higgins and an Advisory Group. It set out a high level, strategic blueprint for Scotland's investment bank as a unique new public institution and cornerstone body in Scotland's economic architecture.

The Scottish Government accepted all 21 of the recommendations in the Implementation Plan. Subsequent parliamentary consideration of this approach confirmed the need for a Bank with ambition and vision to address Scotland's economic priorities in a sustainable, inclusive and ethical way.

In the Programme for Government 2018-2019, the First Minister announced plans to introduce legislation to formally underpin the bank. Having received parliamentary support in May 2018, the Scottish Government took forward the implementation of these recommendations under various work streams.

In June 2018, Benny Higgins was appointed as Strategic Adviser to the First Minister on the Scottish National Investment Bank.

The Scottish Government ran a further public consultation on the Scottish National Investment Bank during September and October 2018 to help shape the Bill. This was augmented by a series of 21 engagements with key stakeholders.

2019 and onwards

In February 2019, the Scottish Government published independent analysis of responses to the second consultation.

The Scottish National Investment Bank Bill was introduced to Parliament, by the Cabinet Secretary for Finance, Economy and Fair Work, Derek Mackay MSP, on Wednesday 27th February 2019.

The Implementation Plan [4] suggests a shadow bank structure should be operational in 2019 overseeing existing financing activities, which are relevant to the Bank and managing new funding made available to the Bank, as well as implementing its plans to be fully operational during 2020.

It is intended the Bank will be fully operational in 2020, investing in businesses and communities across Scotland.

Figure 1: Bank timeline

Sept 2017

The First Minister in the Programme for Government 2017-18 announced plans to establish a Scottish National Investment Bank

Oct 2017

SG commissioned Mr. Benny Higgins former Chief Executive of Tesco Bank, to develop an implementation plan for the Bank. A Consultation Paper was also issued in October 2017

Feb 2018

An Implementation Plan was launched on 28 February 2018 by the First Minister and Mr Higgins

June 2018

Benny Higgins was appointed as Strategic Adviser to the First Minister on the Bank

Sept 2018

In the Programme for Government 2018-2019, the First Minister announced plans to introduce legislation to formally underpin the Bank

Sept and Oct 2018

The Scottish Government ran a further public consultation on SNIB

27th February 2019

The Scottish National Investment Bank Bill was introduced to Parliament

2020

It is intended the Bank will be fully operational in 2020, investing in businesses and communities across Scotland

What is a national investment bank?

A national investment bank, at the most basic definitional level, is a bank created by a country's government, that provides financing primarily for the purposes of economic development of the country.

A renaissance in national investment banks

An article by the Global Government Forum [5] suggests that national investment banks have experienced something of a renaissance in Europe since the 2007-08 financial crisis. Primarily, because national investment banks played an important counter-cyclical role in scaling up lending as commercial banks experienced credit difficulties.

Similarly Mazzucato [6] outlines a trend whereby private markets retreated from financing the economy, whilst simultaneously the economy itself became increasingly financialised. This trend resulted in public finance becoming more important for capital investments.

The Global Government Forum article states that Europe has some of the oldest and newest development banks in the world. While the establishment of some banks was linked to the post-war Marshall Plan, many have launched since the 2007-08 financial crisis. The Bulgarian Development Bank was created in 2008; France’s Bpifrance in 2012; the British Business Bank, Portugal’s Instituição Financeira do Desenvolvimento and the Strategic Banking Corporation of Ireland all in 2014; and the Latvian Altum bank in 2015.

In the last quarter of 2017, the Development Bank of Wales was launched and the Malta Development Bank held its inaugural board meeting.

Characteristics of national investment banks

In many countries, national investment banks play a key role in financing and directing investment. The fundamental role of these institutions 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.

The Global Government Forum [5] believe that the factors determining the success of a national investment bank include stable macro-economic conditions; a clear and relevant mandate; adequate regulation and supervision; and good corporate governance.

Much of the Scottish Government's inspiration for a national investment bank draws on the academic work of Professor Mariana Mazzucato. The following are examples of national investment banks which are explored in her work [6 7] :

- Business Development Bank of Canada (est. 1944)
- KfW Bankengruppe (Germany, est. 1948)
- Banca del Mezzogiorno (Italy, est. 1952)
- BPI France (est. 2005)
- Japan Finance Corporation (est, 2008)
- British Business Bank (est, 2014)

Mazzucato notes that some national and multinational banks such as the European Investment Bank have been criticised for crowding out rather than crowding in private finance, particularly in offering debt finance to infrastructure promoters. Thus, it will be important that the proposed Scottish National Investment Bank learns lessons from international comparators and avoids such criticism.

Reviews [7] of international comparators show that close alignment between national investment banks and government policy can create a powerful synergy between policy, regulation and financing, which can be coordinated for maximum impact. Given the balance between reserved and devolved powers in Scotland, it is valid to ask whether the Scottish Government has such leverage to make these synergies.

Annex B provides further detail on the characteristics of national investment banks, including the changing role with patient finance.

National investment banks close to home

The **British Business Bank (BBB)** was established in 2014, with a goal to change the structure of finance markets for smaller businesses in the UK, so that these markets work more effectively and dynamically. Since it was established in 2014, it has grown rapidly as an organisation and now has more than 300 employees across Sheffield and London offices.

The BBB is 100% Government owned, but independently managed. The BBB doesn't lend or invest directly. Instead it works with over 100 partners such as banks, leasing companies, venture capital funds and web-based platforms. Businesses apply for finance through these partners who, because they work with the BBB, can lend and invest more, especially to younger and faster growing companies. In total, the BBB works through more than 100 finance partners in the market, to unlock billions of new finance and bring greater choice and information on finance options to smaller businesses.

When the British Business Bank was launched in November 2014, it set a target of £10bn to boost the supply of finance for smaller businesses in areas of the market that don't work well, which they were expected to achieve by 31 March 2019.

It reached this milestone midway through the 2017/18 financial year, 18 months ahead of schedule. As at the end of 2017, it had £12.3bn of stock of finance facilitated, an increase of 33% from £9.2bn the previous year. Of this, £5.2bn went towards SMEs and £7.1bn for mid-cap firms. The increase was driven primarily by the strong performance of the Investment Programme and Business Finance Partnership. Both of these attracted higher than expected levels of private sector investment, demonstrating the powerful catalytic effect that investment can have in unlocking private sector participation.

Source: British Business Bank Annual Report, 2018

The BBB activity in Scotland includes [8] :

- BBB is an LP (limited partner) for the three largest VC (venture capital) funds in Scotland (SEP, PenTech, and Panoramic) with over £80m invested
- in 2017/18 the amount of Scottish smaller business finance leveraged via BBB funding was £467.2m, to over 3,600 businesses (this represents funding deals which the BBB contributed to)
- the Startup Loans programme has issued over 3,300 Startup Loans in Scotland since 2002 (figure from June 2018)
- tech incubator CodeBase is a working hand-in-hand with Accelerated Digital Ventures (ADV) – funded by the British Business Bank, Legal & General (L&G) and Woodford Investment Management – to provide scaleup support and space to build world-class digital businesses in Scotland.

One of newest institutions is the **Development Bank of Wales**, launched in October 2017, which is set to invest more than £400m directly into businesses by 2021-22. The bank aims to ensure that the Wales retains access to finance as private banks retreat. Its Chief Executive stated

> “ the big lenders have retrenched from their very devolved regional structure to a much more centralised structure. That means that if you are in west Wales, for example, you're a long way from a decision-maker and that may just result in you being unable to get finance even though you might have a perfectly good business.”

In its launch year, the bank received from Welsh Government £233 million of new investment. This was allocated across a number of existing and new funds aimed at supporting Welsh businesses as the UK leaves the EU. Its five-year business plan sees the bank achieving an annual investment rate of £80 million by 2022. This will mean investing about £400 million of the bank's funds alongside co-investment from the private sector, at least on a 1:1 basis. This will result in an aggregate figure of £800 million investment that the Welsh economy would not receive without the Development Bank of Wales' activities [9] .

In March 2019, a new £121m funding package to support Welsh businesses navigate through Brexit uncertainty was announced by the Welsh Government. The business finance, drawn from the Welsh Government's existing capital funding, will be delivered by its wholly-owned subsidiary the Development Bank of Wales.

In Scotland, there is already the **Scottish Investment Bank (SIB)**, which was established in 2010 as an expansion of Scottish Enterprise's investment function and has a remit to grow Scotland's risk capital market and support early stage and expanding SMEs with growth and export potential to raise finance. In 2017-2018 SIB [10] :

- invested £43.5 million in 147 Scottish companies
- leveraged over £206 million of investment
- supported over 500 companies through SIB's Financial Readiness Service
- generated £17.6 million of income from SIB investments.

It is intended that the activities of the Scottish Investment Bank will be integrated into the operation of the proposed Scottish National Investment Bank. More details of this integration are discussed in a later section of this briefing.

Why do we need it?

The Scottish Government, in putting together a case for the Bank, has drawn heavily on work by the New Economics Foundation, in combination with input from Professor Mariana Mazzucato in her role as a member of the Council of Economic Advisors and the Bank Advisory Group.

They have identified a number of issues in the Scottish economy that it is intended a national investment bank can start to address, to help the Scottish economy achieve its full potential. The two that were considered most important by the Advisory Group were:

- a need for greater long-term investment in small to medium size enterprises (SMEs)
- Scotland's relative innovation performance lags behind comparator countries.

Issues constraining economic performance

The supporting analysis [11] to the Implementation Plan highlighted the following evidence of issues prohibiting the Scottish economy achieving its full potential. Full sources for the issues noted below are available in the Scottish Government's supporting analysis [11] document. It is intended that the proposed Scottish National Investment Bank will help address these issues.

- A distinct **fall in the growth rate of productivity** since the financial crisis in 2008.
- **Business investment in Scotland has fallen in recent years**. This decline comes after a period of stagnation, which followed a significant decline in the late 90s/early 2000s.
- Several specific **barriers to investment in patient capital** including that the majority of financing is concentrated in London making it difficult for businesses outside the capital to access the funding they require, especially for companies requiring more than £5m in equity investment.
- The **business models of UK banks have shifted** away from relationship based business lending in favour of lending to other financial institutions and mortgage lending. As a result, **since the mid-1980s the share of bank lending going to businesses has been falling rapidly and now represents less than 10% of total lending.**
- A **regional imbalance around equity finance**, where investment (by volumes and value) is concentrated in London and the South East. The analysis shows that whilst Scotland's share of the total number of UK equity deals is broadly in line with its share of UK businesses and business births, its share of the total value of UK equity deals is considerably smaller.
- There is a **later stage venture capital funding gap in the UK**, which is holding back growth companies from scaling-up.
- **Scotland is classed as an innovation 'Follower' and ranks around the middle of EU countries across a composite of innovation indicators**.
- **Scotland performs particularly poorly in terms of Business Expenditure on R&D (BERD)**, ranking 5th amongst 6 comparator countries.
- **Uncertainty around EU funding** which may or may not be replaced at UK level, including CAP, Rural Development, Fisheries and Structural Funds, collectively worth €5.6 billion between 2014 and 2020; as well as the potential loss of access and diffusion of shared developments through the Horizon 2020 programme and European Territorial Cooperation programmes.

The Supporting Analysis [11] highlights data from the Enterprise and Skills Review noting:

> " Scotland's strengths are clear in areas like skills attainment, funding for companies and inward investment. Weaknesses include enterprise, business investment, and business R&D, as discussed earlier. Significantly, the trends suggest that, while most of Scotland's strengths seem to be improving, our weaknesses mostly appear to be getting worse. There is some evidence that many of Scotland's weaknesses are driven by a lack of dynamism in Scotland's business base, with a smaller population of firms, fewer high-growth firms, low levels of entrepreneurship and innovation, and a low business birth rate "

In addition, it is long established that innovation is highly uncertain and has long lead times - thus, achieving smart, innovation led growth requires not just any type of finance, but patient strategic finance.

It is worth highlighting that the Bill and associated Policy Memorandum don't explicitly reference all of the above. The Bill states that Bank's main object '*is giving financial assistance to commercial activities for the purpose of promoting or sustaining economic development or employment in Scotland*'. Sections 2 provides for overarching objectives predominately around the notions of:

- investing in inclusive and sustainable economic growth
- promoting and developing the activities of enterprises, where lack of financial investment is holding back economically viable commercial activity
- promoting and developing the activities of small and medium-sized enterprises
- creating and shaping markets through the provision of patient capital.

At the time of writing, it is not clear what range of output and outcome indicators will be monitored in relation to the impact of the Bank's performance. However, it would be expected that some of the output and outcome indicators should reflect the issues highlighted above.

Rationale for public intervention

The rationale for public sector interventions can be based on strategic objectives, improvements to existing policy, market failure or distributional objectives that the government wishes to meet. Generally, market failure theory is used by policy makers to inform the formulation and evaluation of public investments. The HM Treasury Green Book *(central government guidance in policy appraisal and evaluation)* notes that market failure is where the market mechanism alone cannot achieve economic efficiency. The concept of market failure is explored in more detail in Annex B.

It is the existence of these market failures that justify public spending on capital-intensive areas like infrastructure, uncertain high-risk basic research (a typical public good) and innovation, financing of risky small firms (whose real 'quality' as borrowers is unknown to the investor), or investments in technologies that help to internalise negative externalities.

Mazzucato's 2014 paper [6] discusses how this market failure justification for public intervention and the associated evaluation toolkit has placed national investment banks under increased scrutiny and, in some cases, criticism, because any role beyond fixing market failures is seen as unjustified. The market failure framework does not capture how, in countries that have been successful in achieving 'smart' (innovation-led) growth, the breadth of such public investments has been driven by broad 'mission-oriented' justifications, such as those that drove investments by NASA, DARPA (Defense Advanced Research Projects Agency is an agency of the United States Department of Defense responsible for the development of emerging technologies for use by the military) , etc. Currently, the analytical frameworks used by governments to evaluate policy assume that government interventions are mainly concerned with correcting 'market failures' [12] .

The proposed activities of the Scottish National Investment Bank go beyond a classic market failure correcting role to include a mission-orientated role to make strategic investments, which focus on solving Scottish societal challenges. Given that current analytical frameworks used by governments to appraise and evaluate policy assume that government interventions are mainly concerned with correcting market failures (for example see The Green Book [13]), it is valid to question from the outset how the Scottish Government will be adapting appraisal, evaluation, and monitoring tools in relation to the Bank.

Annex B explores in more detail market failure theory and how the policy approach for the Bank goes beyond a market failure intervention.

A Scottish solution

A key thread running throughout the supporting documentation for the Scottish National Investment Bank is that the variance and specificity of local conditions in Scotland means that local experience, knowledge and focus will be required to deliver the benefits that the Bank can offer.

The Implementation Plan [4] and supporting documents state that when the Scottish and UK economies are examined there are some stark differences that mean that what is needed in Scotland is very different to what is needed elsewhere in the UK.

> “ This issue is strongly exacerbated by the nature of Scotland’s geography and regional diversity and means that it is very difficult to see how a UK based institution such as British Business Bank could develop the local knowledge required to properly serve Scotland fully. This reinforces the notion that a mission led approach that stems from devolved competencies, needs a devolved body to take it forward.”

Related, the Supporting Analysis [11] states that:

> “ In order to carry out such a role with maximum efficiency it is obvious that it must be aligned to the prevailing legislative and regulatory framework. This would suggest that in Scotland, if the mission orientated role stems from devolved policy or competency then there is a strong and clear case that it will require a Scottish institution to implement. ”

Here it should be noted that the Scottish National Investment Bank will also be aligned to and support the Scottish Government's broader policy objectives, including the National Performance Framework (NPF) [14] . The Bank will, in particular, contribute to the following National Outcomes [14] :

- We have a globally competitive, entrepreneurial, inclusive and sustainable economy.
- We have thriving and innovative businesses, with quality jobs and fair work for everyone.

However, the NPF is not referenced in neither the Bill or Policy Memorandum.

How the bank will work

The Implementation Plan [4] , drawing strategic direction from the Scottish Economic Strategy [15] and Programme for Government [2] , states the Bank should adopt the following vision:

> The Scottish National Investment Bank will provide finance and act to catalyse private investment to achieve a step change in growth for the Scottish economy by powering innovation and accelerating the move to a low carbon, high-tech, connected, globally competitive and inclusive economy.

The vision for the Bank is for a long-term cornerstone institution at the heart of the Scottish economy. But again, this vision isn't explicitly referenced in the Bill.

What it will and won't do

- The Bank **will act commercially**, meaning it should target a positive financial return at both an individual investment level and at an investment portfolio level – with the portfolio return target set over the long-term.

- The Bank **will have a financial target rate of return but will also have socio-economic and environmental performance measures related to the National Performance Framework.** The financial target rate of return will be finalised prior to vesting of the company.

- The Bank **will not offer traditional banking services such as taking deposits or offering mortgages**, and as such it will not require a network of branches.

- It **will be for the Bank itself to develop detailed product offerings. These offerings should aim to maximise additionality**. The Bank should focus on, and give priority to, areas of investment that are additional to the finance already provided by the market and by other providers in Scotland. Through doing so, it **will complement rather than crowd-out existing or potential investment**.

- The Bank should **take into account economic, social and environmental returns when making its investment decisions**. A balanced scorecard will be developed between the Bank and SG to establish the requirement and measurement of non-financial returns.

- **Investment should be on an ethical basis** and to guide this principle the Bank should develop a code of ethics that goes beyond regulatory requirements and adopts a best practice approach.

- Much of the Bank’s **investment and lending activities with companies, will be through others. This requires fund management capability or the development of its own asset management structures**.

- It **will not undertake funding activities, such as the awarding of capital and revenue grants** which will remain with the Scottish Government and its agencies.

- The Bank will have a **national mandate to realise benefits of investment at scale, while maintaining regional reach to help businesses to realise their full economic potential across Scotland.** This will be particularly important since Scotland's productivity challenges vary significantly across regions.

- The Implementation Plan [4] states given the scale of ambition for the Bank, and the associated scope of activity, the potential running costs for the Bank when fully established are estimated to be between £20m-£30m per annum. **This would allow for an organisation that would have circa 100-150 people working for it and engaging in a full range of financing activities**. The cost implications of the bank are discussed in more detail in a later section of this report.

Types of products

The Implementation Plan [4] proposes that the immediate areas of activity where the Bank could deliver most additional impact are:

- **Growth Capital:** Supporting companies' growth ambitions, including those businesses which are driven by knowledge and ideas rather than operating with a strong base of fixed and tangible assets. The Bank should do this by providing access to long-term patient finance necessary for ambitious firms to invest in order to grow and turn their ideas into revenues, and also seek to address recognised gaps in the current market for lending to SMEs whose need for finance may be over a short to medium-term horizon.

- **Financing projects that will transform the economy:** To achieve this transformative mission-based remit of the Bank, there will be a need for investment in projects that will help Scotland exploit and accelerate new innovation – these are the 'big ideas' for the economy such as the transition to a low carbon economy. Such projects may require the Bank to play a catalytic role in infrastructure investment (across transport, low carbon, housing, real estate, etc.) providing finance that addresses the reasons why the private sector is not investing. Missions are discussed in greater detail in a later section of this report.

The Implementation Plan [4] suggests the following initial financial product range for the Bank to focus on:

- Provide SMEs with access to micro loan finance of up to £100k by the continuation of the existing activities enabled by the Scottish Government's SME Holding Fund.

- Expand the offerings of loan finance to SMEs by providing short to medium-term loan finance (senior and mezzanine debt) in the range between £100K and up to £1m-£2m for which there is currently unsatisfied demand.

- Consider the potential to deliver targeted debt support through the creation of specific loan funds, such as the Brexit Loan Fund established by the Strategic Banking Corporation of Ireland.

- Provide early stage risk capital equity up to £2m currently provided by the Scottish Investment Bank via its co-investment funds.

- Provide other targeted equity and mezzanine investment models for amounts up to £2m, whilst also providing scale-up investment finance by way of equity and loans up to £10m, and above, where opportunities are identified.
- Mission-based finance could be both debt and equity depending on the analysis of the gap or market opportunity, but focused on the transformative change agenda set by the Programme for Government.

The Bill makes no reference to the types of products that that bank will provide. However, it does note that the Articles of Association must mention the following as examples of financial assistance given by the Bank may take:

- (a) investment by the Bank (alone or with others) through the acquisition of loan or share capital in any company
- (b) investment by the Bank (alone or with others) through the acquisition of any
    - (i) undertaking, or (ii) assets
- (c) a loan (secured or unsecured, and with or without interest)
- (d) insurance or a guarantee to meet any contingency (including default on payment of a loan or any other failure to fulfil a contractual obligation).

Making investment decisions

It is intended, according to the Implementation Plan, that investments will be through a variety of instruments, including debt, guarantees, equity and mezzanine finance, to suit the profile of additionality, risk, and wider economic, social and environmental objectives underlying investment.

Ensuring additionality

It is intended that the Bank will provide additionality to the existing investment and financing market in Scotland. In order to provide additionality to this market, the Bank will need to invest in firms whose needs for capital the market is not adequately servicing already. There reasons for a lack of investment are often complex, and it will be important for the Bank’s management team to ensure that its interventions take account of the reasons for the lack of investment in the current market.

Additionality is not referenced in the Bill or Policy Memorandum.

Expectation of return

In some cases, it will invest parri passu on the same commercial terms and taking the same returns as the private sector. In other areas (e.g., where state aid allows in response to specific market failures) it may take different risks or different returns to the private sector, but always in expectation of a return. This will be assessed alongside the wider economic, social and environmental impacts.

In order to be additional, while the Bank will seek full market returns in some circumstances, in will inevitably in some circumstances need to look for lower and/or longer-term returns than the private sector would for specific risks, accepting a lower overall return and engaging in activity the private sector on its own would not have the appetite for.

The concept of the level of return is referenced in the Policy Memorandum but not the Bill.

Looking beyond financial returns

The Supporting Analysis [11] notes that it would be desirable for the Bank to have a range of criteria by which it makes investment decisions. While financial and monetary returns on investment will be key, the supporting documentation states the Bank should also look at wider economic, social and environmental objectives.

The Supporting Analysis [11] provides examples of Multi-Criteria Analysis (MCA) to illustrate the wider benefits and difficulties of different types of investment interventions. The supporting documentation states this form type of MCA should form the basis, along with more formal economic modelling, for the assessment of potential actual interventions for the Bank. Furthermore, it is noted that MCA analysis represents a strong potential basis for a balanced scorecard approach to the assessment of the Bank's performance once operational. This scorecard approach will include measures of economic, social and environmental performance as well as tracking the financial outcomes from investments (see Recommendation 7 from Implementation Plan).

This concept of looking beyond financial returns isn't explicitly referenced in the Bill or Policy Memorandum.

Collaboration and integration

Stimulating demand

A key recommendation of the Implementation Plan [4] is that the bank should coordinate with other entities seeking to stimulate demand for financing. In financing transformational projects, the Bank will need financial structuring and complex transactional skills and consequently an element of demand stimulation will be required in this area, working closely with the enterprise agencies (Scottish Enterprise, Highlands & Islands Enterprise, soon to be formed South of Scotland Enterprise) who provide a range of support services to companies, and with the Scottish Futures Trust in relation to its activities on infrastructure.

In order to reach growing firms, the Bank's partnership working with the enterprise agencies in particular and other market participants will be essential.

Policy landscape alignment and consolidation

The Implementation Plan [4] intends that the Bank will build on the success of existing financing operations within Scotland and that there will be clear alignment with the Bank's agenda and the wider Scottish policy landscape.

It is intended that financing activities undertaken by and on behalf of the Scottish Government, such as Scottish Enterprise's Scottish Investment Bank and the provision of funding for loan and equity finance schemes (for example, under the SME Holding Fund and the Scottish Growth Scheme) should sit within the Bank allowing the Bank to utilise the strengths and skills already developed and build on the positive foundations laid by the work of the Scottish Government and its agencies. It is hoped that this consolidation will ensure a greater coherence for those firms looking for finance by simplifying the existing public sector landscape.

The Draft Budget 2018-19 [3] established a new £150m Building Scotland Fund (£80m in 2018-19 and £70m in 2019-20). It is proposed that this fund's remit, and investments made, will transfer to the Bank in 2019-20 when it is operating in interim or 'shadow' form, pre-incorporation.

More widely, it is envisaged that existing business advice and support provided on behalf of Ministers by the enterprise agencies and infrastructure advice via Scottish Futures Trust should also be co-ordinated with the Bank's activity, so that the whole ecosystem works effectively together.

Wider coordination

The Bank's activities should also be aligned with non-Scottish Government financing activity in Scotland, including that of the British Business Bank, to ensure that access and opportunities for financing, investment and economic growth are complementary and maximised. The Bank should seek to lead the development of a co-ordinated strategy to achieve this.

Potential areas at a later stage

The Supporting Analysis [11] highlights the following as areas in which the Bank should not have a defined interest at launch, but which may be part of developing the Bank in later stages or in response to changing government priorities. They note that these are areas in which there is either a danger of crowding out private investment or intervention is especially difficult.

- Real estate finance, supporting the general sector of building and construction.

- Intervention as a regulated bank, including the potential to take deposits. This could be considered if a need was identified for additional bank credit products that should provide but would face considerable implementation difficulties. The proposal would need to be precisely developed to gain approval and could be developed as the Bank got up and running but should not be a prerequisite for action.

What does the bill do?

The previous sections of this report have summarised the intentions and aspirations for the Scottish National Investment Bank, as developed in the Implementation Plan [4] which was fully accepted by the Scottish Government.The Bill itself is very much an enabler bill, thus much of these intentions and aspirations are not obvious from the Bill.

The Bill describes the relevant powers of the Bank in broad terms but leaves a lot of the detail to the Articles of Association (that is to say the constitution of the Bank as a plc). The Bill does not confer any powers in itself, rather it sets out what the Bank's Articles of Association will have to say about its powers.

What the Bill does do is place a duty on Scottish Ministers to establish the Scottish National Investment Bank, as a public limited company, and gives the necessary powers to Scottish Ministers to capitalise the Bank. Scottish Ministers will also be given the power to set the strategic direction of the Bank by the setting of Missions.

The Bill places a duty on the Scottish Ministers to provide the Bank with its Articles of Association and mandates what is to be in the Articles and the circumstances in which certain provisions can be modified. The Bill also makes provision for the annual reporting and performance review (every five years) of the Bank. The Schedule of the Bill makes provision for the application of public bodies legislation to the Bank.

Various reports and document types are mentioned in the Bill and the wider suite of supporting material. Across the Bill and the suite of accompanying material, it can be confusing to understand the range of documents/reports that will assist the operation of the Scottish National Investment Bank. Using all available supporting material, we have created a list in Annex A to help understanding.

The Bill comprises of three parts and 25 sections.

- **Part 1 (sections 1-10) of the Bill focuses on the establishment of the Bank and sets out:**
    - Scottish Ministers duty to establish
    - The Bank's objects and articles of association
    - General powers and borrowing powers
    - Ownership
    - Appointment and tenure of directors
    - Remuneration
    - Risk and Audit Committee functions
- **Part 2 (sections 11-20) of the Bill looks at operational matters related to the Bank:**
    - Setting and reporting of missions
    - Accountability – reporting and reviewing performance
    - Scottish Government financing of the Bank
        - Power to capitalise
        - State aid requirements prior to significant capitalisation
        - Power to finance
        - Requirement for state aid approval for grants
        - Meaning of state aid rules
    - Modification of entrenched articles of association
- **Part 3 (sections 21-25) of the Bill covers final provisions**:
    - Application of public bodies legislation
    - Meaning of references to the Bank
    - Ancillary provision
    - Commencement
    - Short title

Section details

Sections 1-10 establishment of the bank

Section 1 places a duty on the Scottish Ministers to establish the Scottish National Investment Bank as a public company limited by shares. The Scottish National Investment Bank p.l.c is to have its registered office in Scotland and be owned solely by the Scottish Ministers. The Bank's Articles of Association are to be framed in accordance with Chapter 2 (the Bank's Articles of Association on establishment) of the Bill.

The Bank's purpose and objects, as set out in section 2 of the Bill, support the two pillars of Scotland's Economic Strategy which are: increasing competitiveness and tackling inequality.

Section 3 of the Bill describes the relevant powers of the Bank in broad strokes. But it does not confer any powers in itself, rather it sets out what the Bank's articles of association will have to say about its powers.

Sections 2 and 3 provide for overarching objectives predominately around the notion of 'investing in inclusive and sustainable economic growth', which it could be argued may have different interpretations depending on the understanding of the terms 'inclusive' and 'sustainable'. However, given the vision for the Bank is linked to the Scottish Government's Economic Strategy [15] , it is likely here that the terms refer to the policy objective of delivering 'inclusive and sustainable economic growth' as set out in the Economic Strategy.

Borrowing powers

Section 4 makes provision, for inclusion in the Articles, about the borrowing powers of the Bank.

- The Bank will not issue bonds or public shares. As set out in section 4 of the Bill, the Bank can only borrow from the Scottish Ministers. The Bank will lend solely to the private sector. It will not lend to public institutions including local authorities, government agencies or arms-length bodies.

- Under the fiscal framework agreement between the Scottish and UK governments, the Scottish Government has limited powers to borrow finance. Borrowing by the Bank from parties other than the Scottish Ministers would be counted towards the Scottish Government's borrowing limit. Restrictions are therefore placed on the Bank's ability to borrow to ensure it does not impact upon the Scottish Government's fiscal position.

Articles of Association

Entrenched articles

These are additional clauses in articles to make certain provisions more difficult to change than passing a special resolution. Any clause that requires more than a special resolution to be amended is known as an 'entrenched provision' under the Companies Act 2006 (Section 22). More details are available from: https://www.legislation.gov.uk/ukpga/2006/46/section/22

In establishing the Bank, the Scottish Ministers will be required to prepare the Bank's Articles of Association . The Bill mandates in sections 2 to 9 what is to be included in the articles.

- The Bank will be free thereafter to amend its articles, just like any other public limited company with the exception of those articles which are entrenched under section 10.
- Where an article is entrenched the Scottish Ministers, as a member of the Bank, will need the approval of the Parliament (via a Scottish Statutory Instrument) to amend the article.

To safeguard certain aspects of the Bank's character, the Bill makes provision for these Articles to be entrenched, as set out in section 10 of the Bill. These entrenched articles include the Bank's objects and purpose, its ownership, borrowing powers, the appointment processes for its board and the relevant tenure and remuneration principles for these positions and how its committees will be established. This ensures that if the Bank's board wishes to change or repeal any of the Bank's operations which fall within the remit of these articles, parliamentary approval will need to be secured. In particular, the article which outlines the Bank's ownership is entrenched (section 5) so that the Scottish Ministers cannot sell their shares to another party, ensuring the Bank remains within the public sector unless parliamentary agreement is reached to permit otherwise.

It should be noted that if the Bank were legally challenged, it would be the Articles of Association that would be interpreted in a court of law and not the principles of primary legislation.

Appointment of Directors to the Board

Section 6 makes provision, for inclusion in the Articles, about the appointment of Directors to the Board of the Bank.

The Bill sets out the composition of the Bank's board. The Bank's board will consist of a chair and between 9 and 13 directors including the chair. The chair and non-executive directors will be appointed by the Scottish Ministers. The Bill also makes provision for the appointment of at least two executive directors, namely a chief executive and a chief financial officer, to be appointed by the board. Further to this, the Bank's board will be established in line with the Scottish Government's 'On Board' guidance for public boards and the Gender Representation on Public Boards (Scotland) Act 2018 which sets an objective for public body boards that 50% of their non-executive members are women.

Audit and risk committees

Section 9 of the Bill sets out a duty for the board to establish an audit committee and a risk committee, both chaired by a non-executive director. The board will determine which subcommittees are required and which board members will sit on them. As a public body the Bank will be subject to existing public bodies legislation. As the Schedule of the Bill sets out, the Bank will be subject to the Ethical Standards in Public Life etc. (Scotland) Act 2000; the Freedom of Information (Scotland) Act 2002; the Public Appointments and Public Bodies (Scotland) Act 2003; the Public Services Reform (Scotland) Act 2010; and the Gender Representation on Public Boards (Scotland) Act 2018 as noted above. Furthermore, in the Equality Impact Assessment [16] the Government has committed to bring forward secondary legislation to make the Bank subject to the Public Sector Equality Duty and the Fairer Scotland Duty.

Sections 11-20 operational matters

Mission approach

Broadly speaking, the Bank will take a mission-based approach to investment. This means that the Scottish Ministers set the strategic direction of the Bank by identifying a set of medium term outcomes and focus for the Bank, which will be set out as described in section 11 of the Bill. According to the Policy Memorandum, this mission-based approach provides a unique opportunity to channel public finance to support transformational change across a number of socio-economic challenges.

Section 11 of the Bill gives the Scottish Minister the power to set the direction of the Bank by the setting of strategic missions. These will be set by the sending of a document to the Bank by the Scottish Ministers setting out the socio-economic challenges that the Bank is to seek to address. Scottish Ministers may set, modify and bring missions to an end by the sending of such a document. The document must be made publicly available and be laid before the Scottish Parliament. However, there is no further parliamentary procedure attached to this requirement, such as a parliamentary vote to approve the document. It is intended the strategic missions set by the Scottish Ministers will complement the Bank's objects.

The Bill sets out the duties of the Bank to report to the Scottish Ministers on how its intends to respond to the missions sets for it, as well as an annual report on investment performance. Section 12 provides that the Bank must provide a report to the Scottish Ministers setting out how it intends to respond to the strategic missions set for it within three months of receiving a document in relation to its strategic missions unless it has done so in the last three months, or is scheduled to do so in the next three months. This report may be issued as part of another document. Missions are detailed further in a subsequent section of this report.

Performance reporting

The Bank will also report on its investment performance each financial year. The Bank must also provide information on the performance of its investments at any other time should it be directed to do so by the Scottish Ministers.

It is expected that this annual report will be made publically available in line with Scottish Government commitments for the Bank to be established and run according to the principles of Open Government. However, the Scottish Government has included the flexibility in the legislation to accommodate the possibility that an annual report may include some commercially sensitive information that should remain between the Bank and the Scottish Ministers in their capacity as sole shareholder. In that case partial publication of the report (without the sensitive information) may be more appropriate.

Section 14 provides that the Scottish Ministers must, at least every five years, appoint a person to review the performance of the Bank, and the performance of any subsidiaries of the Bank, and prepare a report of that review. The Scottish Ministers must lay a copy of that report before the Scottish Parliament, and make it publicly available.

Capitalisation

Section 15 of the Bill provides powers to the Scottish Ministers to capitalise the Bank. The Bank will be initially capitalised by the Scottish Government to the level of £2 billion over the first 10 years. There is a detailed section on capitalisation in a later section of this report.

As set out in section 16 of the Bill, before fully capitalising the Bank, the Scottish Ministers must first secure the relevant permissions from the European Commission to comply with State aid rules.

Section 16 provides that the Scottish Ministers may not spend more than the authorised minimum on capitalising the Bank unless any approvals necessary under State aid rules have been obtained. Under section 763 of the Companies Act 2006, the minimum share capital needed to establish a public limited company is £50,000.

Section 16 permits sufficient capitalisation to allow the Scottish Ministers to establish the Bank as a public limited company. However, State aid approval is required to capitalise the Bank to the level which would enable it to fulfil its object and ancillary objects. According to the Policy Memorandum, this approach allows for sufficient flexibility to allow the Bank to be established and resourced so that it is able to undertake the entirety of its functions once State aid approval is given.

Power to finance

Section 17 provides that the Scottish Ministers may provide such finance to the Bank as they consider necessary and that this includes taking and paying for shares in the Bank as well as the giving of grants, loans or guarantees.

Section 18 provides that the Scottish Ministers may not provide finance to the Bank unless any approvals necessary under State aid rules have been obtained.

Section 19 makes provision as to the meaning of State aid rules.

Missions

A key innovative aspect of the Bank is the 'mission-oriented' approach that will steer its investments. This means that the Bank will not simply seek to 'fix' market failures, but will also create and shape new markets aimed at tackling modern societal challenges. A previous section of this report looks at market failure and the rationale of intervention.

The argument made by Mazzucato [6] and endorsed by the Scottish Government is that, faced with complex societal problems, such as climate change, an aging population or major technological change impacting on the labour market, what is needed is a mission-oriented role that cannot be provided by the private sector.

Section 11 of the Bill gives the Scottish Ministers the power to set the direction of the Bank by the setting of strategic missions. These will be set by the sending of a document to the Bank by the Scottish Ministers setting out the socio-economic challenges that the Bank is to seek to address. Scottish Ministers may set, modify and bring missions to an end by the sending of such a document. The document must also be laid before the Scottish Parliament and made publicly available. The strategic missions set by the Scottish Ministers will complement the Bank's objects.

Ministers will not have a role in the Bank's internal governance or the operational decisions made by the Board. It will be for the Bank to decide how it will direct its activities to respond to missions through its Investment Strategy. The Investment Strategy will be periodically revised and updated by the Board, taking account of any adjustments to the target rate of return and missions, as well as market conditions.

A framework approach

UCL Institute for Innovation and Public Purpose has developed an overview of a mission-oriented framework, and how it can be applied to the Scottish National Investment Bank.

The framework [12] advises that missions should be broad enough to engage the public and attract cross-sectoral investment; and remain focused enough to involve industry and achieve measurable success. By setting the direction for a solution, missions do not specify how to achieve success. Rather, they stimulate the development of a range of different solutions to achieve the objective. The framework states that mission-oriented policy is underpinned by a number of key principles:

- picking the problem, not sectors
- focusing on societal relevance: all missions should have societal relevance for a large section of Scottish citizens
- no ‘one size fits all’: missions come in different shapes and sizes
- fostering experimentation: missions must be chosen, yet their success will depend on the bottom-up processes that nurture innovation while ‘getting there’. A culture of experimentation and risk-taking is a crucial element in the philosophy of missions.

More detail on the Framework document and mission criteria are discussed in Annex B.

International example

KfW in Germany provides an example of a national investment bank using a mission approach to investment [12] . While initially KfW’s lending focused on the reconstruction of postwar Germany, today all investments must contribute to at least one of three preestablished missions, or ‘megatrends’:

- Climate change and the environment: KfW finances measures to support renewable energy, improve energy efficiency, safeguard biodiversity and prevent and/or reduce environmental pollution
- Globalisation and technological progress: KfW contributes to strengthening the international competitiveness of German companies by granting loans in the following areas, among others: research and innovation, projects to secure Germany’s supply of raw materials, and infrastructure and transport.
- Demographic change: KfW’s objective is to address the consequences that result from a declining and ageing population, including the following focus areas: age-appropriate infrastructure, vocational and further training, family policy and childcare as well as corporate succession.

SNIB's potential missions

The implementation plan [4] for the Scottish National Investment Bank cited the following areas as potential themes for missions, based on existing Scottish economic policy:

- Transitioning to a low-carbon economy, including decarbonisation of the transport network.
- Responding to emerging demographic pressures, including the twin challenges of an ageing population and wider population health.
- Promoting inclusive growth through place-making and local regeneration, including site preparation, infrastructure (transport and communication links), housing and related commercial, education and health investment.

The framework [12] states that missions must be widely perceived to be legitimate and of high societal importance. This will ensure their durability and survival across political cycles.

The implementation plan for the Scottish National Investment Bank recommended that the Scottish Government establishes a five-year Strategic Framework to set, monitor and, where appropriate, amend the overall missions for the Bank and the rules or parameters within which it will invest. It also recommends that an advisory group comprising representatives from stakeholders and wider civic society should be established to advise Ministers on the Bank’s Strategic Framework, and that the Chair of this group should have a place on the Bank’s Board as a Non-Executive Director.

Mazzucato [12] believes that

> “ this is a good starting point, but steps must be taken to ensure that the input of the advisory group is meaningful, and that members are drawn from a diverse cross-section of society. ”

It is likely the Bank's missions will align with the National Performance Framework (NPF) [14] . In connecting to the NPF the Bank will ensure its work contributes towards achieving Scotland’s National Outcomes.

Complementary policies, regulation and alignment with the enterprise agencies will be necessary to achieve the Bank's missions and ensure there are viable firms and projects that can be brought forward for financing by the Bank. Thus, it will be important to outline where the missions currently align with Scotland’s Economic Action Plan (EAP) [17] and where there may be gaps that may be filled by the Bank’s activity. The EAP consists of 9 themes: Skills, Innovation, Investment, International, Enterprise, Innovation and Enterprise, People, Place, and Sustainability.

Monitoring frameworks will need to be established to measure progress. Mazzucato believes these must be dynamic, recognising that static cost-benefit analysis and net-present value calculations may stop any bold mission from the outset. Related is this report's previous comment on the validity of current policy appraisal, evaluation, and monitoring tools which centre around market failure theory.

Consultation

The Scottish Government launched two public consultations to gather views and to shape the Bill.

- The first consultation aimed to identify the Bank's potential remit and structure which would support the creation of an Implementation Plan.
- The second consultation looked to refine how the Bank will operate, how its relationship with Ministers and wider population will develop and how its strategic direction will be set by the missions for the Bank, namely socio-economic challenges the Bank is to seek to address through its investments.

Engagement levels

First public consultation

The first public consultation ran from 20 October 2017 – 20 November 2017. A total of 1,108 responses were received:

- 40 responses from organisations
- 311 responses from individuals
- 753 responses via a Friends of the Earth's Campaign

The Scottish Government published full analysis of responses to the 2017 consultation on their website.

Second public consultation

The second public consultation ran from 05 September 2018 – 31 October 2018. A total of 1,443 responses were received:

- 40 responses from organisations
- 20 responses from individuals
- 1,383 responses via a Friends of the Earth's Campaign

The Scottish Government published full analysis of responses to the 2018 consultation on their website.

Friends of the Earth Campaign

Friends of the Earth Scotland, co-ordinated responses amongst their members and supporters. These campaign responses were based on a standard text provided by the organisation and were submitted to the Scottish Government's dedicated Bank email inbox. Respondents were also given the option to edit the standard campaign response and add their own comments.

1,383 responses were submitted through the Friends of the Earth Scotland campaign response. Of these 1,383 responses, 1,360 used a standard template, therefore, for the purposes of analysis this was captured as 1 response. The remaining 23 had some form of variation, and were analysed separately.

The standard email campaign response written by Friends of the Earth Scotland is as follows:

"To the Scottish Government,

I am writing to officially respond to the consultation on the Scottish National Investment Bank Bill.

I welcome the Scottish Government's proposals to create a new publicly-owned ethical investment Bank.

The vision of the Scottish National Investment Bank should be to provide finance and act to catalyse public and private investment for the move to a low carbon and inclusive economy.

The Bank's lending should realise this vision by investing in projects which demonstrate significant cuts in carbon emissions, such as offshore wind, public transport, solar and renewable heat.

The Bank's ethical lending criteria must rule out investing in poor employers and polluting projects. The Bank's activities should align with plans for delivering the Scottish Climate Change Act's targets and the Scottish Government should explicitly rule out lending to fossil fuel projects.

Yours sincerely,"

Additional consultation and engagement

In addition to the two public consultations, 9 stakeholder workshops and 12 bilateral meetings were held between 26 September 2018 and 1 November 2018 with key stakeholders from within the Government and from business.

Within the Scottish Government, the Bank's Programme Board who has responsibility to oversee the programme to set up the Bank includes representation from across the Government including Human Resources, Housing and Social Justice, Social Security and Budget and Sustainability, were consulted through a series of internal workshops [18] .

Alongside the public consultation exercise on the Bill, a series of bilateral events were held with representatives from business. These businesses were primarily private investors who currently provide finance within the Scottish market. Based on these consultations, proposals were revised to take into account stakeholder views. For example, it is now proposed that the Bank may offer guarantees once it is established, if it wishes to do so, following stakeholder advice on this issue.

Feedback

The majority of responses to both consultations were positive towards the proposition of the Bank. This included respondents expressing interest in engaging with the strategic development process.

A significant number of respondents saw the creation of a new investment bank as an opportunity to improve the current investment landscape in Scotland and to develop sustainable economic growth such as the Bank's proposed mission to support Scotland's transition to a low carbon economy.

The overarching opinion was that the Bank's culture, governance, approach to businesses and individuals must be different to that of other financial institutions

Some respondents expressed scepticism in the current private finance sector and some respondents, specifically those responding via the Friends of the Earth Scotland Campaign, remarked that investing in socially-minded local projects, provided an opportunity for the Scottish Government to adopt a more ethically responsible investment approach.

A significant number of respondents supported the Bank's governance arrangements and primarily the proposal that the Bank should be accountable to Scottish Ministers, whilst maintaining operational independence. Some respondents supported the public limited company model suggested. Some respondents agreed with the method of capitalisation. Several respondents agreed that the Bank should be operated and kept within the public domain.

Some respondents suggested the Bank's Board should comprise of around 8-12 people. Several respondents were supportive of involving a wide range of stakeholders in the governance of the Bank and having a wide representation within the governance structure.

Counter views

Whilst many respondents supported the proposal, a small number opposed the development of the Bank. These respondents countered that the creation of a new Bank would not contribute anything new to the sector and would only duplicate services already available via existing public sector bodies or in the private sector.

Other respondents expressed concern that such a Bank could contort the stability of the free market, and 'crowd out' private finance which would in turn prove detrimental to the Scottish economy.

As detailed in the Bill's Policy Memorandum [19] , some respondents commented that the capitalisation was inadequate to deliver the transformative impact desired. While these concerns around capitalisation are understood, international comparison indicates public capitalisation of national promotion banks typically ranges between 0.5% and 1.5% of

GDP. The Policy Memorandum states that in the Scottish context £2 billion broadly equates to 1.3% of GDP, so £2 billion is a realistic and a comparable level.

Some respondents were also of the view that as a public sector body, the Bank could be vulnerable to political pressure or manipulation, which could lead to the Bank making inferior investment decisions.

Equality impact assessment

An Equality Impact Assessment [16] (EQIA) has been prepared in respect of the Scottish National Investment Bank Bill and the establishment of the Bank, and published on Scottish Government webpages. The EQIA sets out how the commitments regarding the way the Bank operates will be met. The EQIA will be updated throughout 2019.

As a result of the EQIA process the Scottish Government considers that the Bill's provisions will not negatively impact on protected groups, but does identify a number of areas Bank to ensure that equality issues are properly addressed and progress furthered wherever possible. The EQIA process also identified potential positive impacts resulting from the creation of the Bank. For example, action undertaken by the Bank may address specific barriers to finance that inhibit advancement of equal opportunities including access to finance for women-led businesses and for female entrepreneurs, and access to finance for businesses owned by ethnic minorities and for entrepreneurs from an ethnic minority.

Alternatives options

The Policy Memorandum [19] tells us that an alternative **approach would be to not establish a national investment bank**, maintaining the status quo.

- This approach would not address the current need to improve Scotland's innovation performance. Establishing a national investment bank would provide an opportunity to transform the Scottish economy. Such an institution would act as a catalyst for innovation, crowding-in investment from the private sector into markets where finance is not currently available.

- It is also understood that SMEs in Scotland currently struggle to secure later stage and longer-term finance to support growth. By choosing not to establish a national investment bank, the benefits to support and stimulate SME growth would not be realised.

- The Bank will be capitalised in part by transfer of financial transactions which can only be used to invest in the private sector through loan and equity arrangements. If the Bank were not established, a different approach would be required of the Scottish Ministers as to how these financial transactions should be invested in the private sector. The Scottish Government could invest financial transactions through existing funding mechanisms however, without a Bank in place, the additional benefits of the Bank's co-ordinated approach to spending Financial Transactions through a mission-oriented approach would not be realised.

Alternative company operating models where also considered.

- While it was deemed feasible to create the Bank as a **private limited company**, this operating model was not chosen because if the Bank were to raise finance from wider sources in the future (for example, a public bond or share issue) it would have to change to being a public limited company.

- The **company limited by guarantee** model was also rejected as this model would restrict the Bank from issuing dividends to the Scottish Ministers. The Scottish Government would like to retain this option to consider how the surplus funds from the Bank might be utilised in the future.

- The **Community Interest Company** model was also considered, however this model introduces an additional layer of regulation as well as a lock on assets.

According to the Policy Memorandum, the public limited company model is considered the most appropriate model for the Bank. This model will allow the Bank to raise capital from a range of sources and will allow the Bank to issue dividends to the Scottish Ministers. The adoption of the public limited model also includes additional protections within the Bank's articles. For example, to ensure that share ownership remains with the Scottish Ministers, and that the Bank's borrowing is zero unless the Scottish Ministers or the Scottish Parliament approve a different arrangement in future.

Classification

The issues of classification is directly linked to capitalisation of the Bank. The Bank's classification status in the National Accounts, a decision formally made by the Office for National Statistics, is determined by the level and form of control exercised by Ministers. This has implications for the Bank's operational arrangements, initial and future capitalisation, funding requirements and treatment in the National Accounts.

There are a variety of classifications under which the Bank could be treated. All have different implications, in terms of the impact on Scottish Government budgets and the Bank's ability to bring in private sector capital. And consequently its ultimate scale given budgetary constraints. The Bank could either classified as:

- a nondepartmental public body (NDPB) or General Government (GG)

- a Public Financial Corporation (all of which are classified as public sector)

- a Private Financial Corporation.

The Implementation Plan [4] proposes the Bank should be a public body, classified to the public sector to ensure direct alignment between the activities of the Bank, the broader economic policy and the Scottish Government's enterprise and skills agencies.

Where a Bank type body does not fit Eurostat guidance as to a financial corporation and where it is owned and/or controlled by the public sector, it will be classified to General Government. This would be the case if the Bank was set up as an statutory NDPB or as a limited company (in which case it would be a non-statutory NDPB). Consequently, the Scottish National Investment Bank will be recognised as non-statutory NDPB, classified to General Government.

The Bank's initial governance and funding means that it is likely to be classified to central government with all of its activities scored against Scottish Government budgets. Over time, it could be advantageous for the Bank's classification status to change, to say for example to a Self-Financing Public Corporation, if it were to generate sufficient income from external sources and revised governance arrangements were put in place to ensure fully independent decision-making.

In terms of the Bank's ability to operate efficiently, the benefits of that alternative classification would include the ability for the Bank to carry and deploy reserves whilst minimising the impact on the Scottish Government's budget. Whilst it is only for the Office of National Statistics to determine the classification status of bodies, any proposal for change in the Bank's governance and control arrangements would be subject to review and there would be an opportunity for the Scottish Parliament to consider the options.

Financial implications

To realise the Scottish Government's ambitions for the Bank, the Implementation Plan recommended that it be initially capitalised by the Scottish Government to the level of £2 billion over 10 years, that it should operate on a commercial basis and that the Bank be able to retain receipts for recycling and growing the Bank's investment base.

- The Bank will need to secure permission from European Commission to comply with State Aid rules. Particularly, as in some circumstances the Bank may choose to offer products at sub-commercial rates, which may be deemed to be allowable state aid.

- For the Bank to be able to reinvest its financial returns, it will need to secure a dispensation from HM Treasury to have the flexibility to manage, retain and carry-forward cash balances over financial year-ends.

Both of these requirements are discussed at the latter end of this chapter. According to the Financial Memorandum total costs to the Scottish Administration will be £2,050 million, as illustrated in Table 1.

Table 1: Costs to the Scottish Administration (note different timelines on spend lines)

	£ millions
Capitalisation ***(2018-28)***	2,000
Scottish Government Bank Programme ***(2018-21)***	23
Set up costs for the Bank ***(2020/21)***	5
Scottish Government sponsor unit ***(2020-23)***	4
SG contribution to operating costs of the Bank ***(2020-23)***	17.9
Total	**2,050**

Scottish Government, 2019[20]

Points to note when interpreting the costs.

- The Financial Memorandum is heavily caveated around likely changes to the cost estimates because much of the estimates are based on planning conducted to date. The Financial Memorandum states that these will be refined as operational planning progresses.

- Some of the spend streams will continue beyond the period profiled in the Financial Memorandum, such as the sponsor unit costs, which will go on beyond 2023.

- Modelling indicates that the Bank should be self-funding after 2022/23. However, if the Bank doesn't perform as expected, the Scottish Government's contribution to operational costs may continue longer than indicated in the Financial Memorandum.

- The Financial Memorandum doesn't provide any detail on the level of scenario, risk, and sensitivity analysis completed around the estimated costs.

Capitalisation

The Financial Memorandum [20] states that the levels are thought to be both ambitious and achievable, and will enable the Bank to make a substantial difference to the Scottish economy. This commitment to capitalising the Bank was reflected in the draft budgets for both 2018-19 and 2019-20 , which provided initial allocations for pre-cursor investment for the Bank, including £150 million for the Building Scotland Fund over 2018-21 and a further £340 million over 2019-216 . The Bank will be further capitalised by an additional £1.5 billion between 2021 and 2028

Table 2: Capitalisation costs of the Scottish National Investment Bank

£m	2018-19 Budget	2019-20 Draft Budget	Identified for 2020-21	Future budgets over 2021-28	Total
Building Scotland Fund	70	50	30	-	**150**
Funding for other precursor investment	-	120	220	-	**340**
Capital to be provided (£216m pa average)	-	-	-	1,510	**1,510**
Total	**70**	**170**	**250**	**1,510**	**2,000**

The timing of the further capitalisation between 2021 and 2028 will depend on future budgets agreed by the Parliament, as well as other factors including: demand for the Bank's products, the Scottish Government's wider capital programme, the Bank's forward projections in terms of capital coming back from investments (for example, through the Building Scotland Fund), and the year-end flexibility arrangement. The level of capitalisation set out in the Financial Memorandum will be contained within Scottish Government's annual budgets and will be included within long term planning projections.

The proposed capitalisation of the Bank to 2021 is to be provided through Financial Transactions (FTs). FTs are a form of capital budget allocated by HM Treasury to the Scottish Government which can only be used for the provision of loans or equity investment beyond the public sector. They cannot be used to provide grant or fund public services. Financial Transactions facilities provided by HM Treasury have to be repaid by the Scottish Government in future years. Where FTs are used to capitalise the Bank, liability for repayment to HM Treasury remains with the Scottish Government and does not transfer to the Bank.

Capitalisation of the Bank after 2021 will be made from Scottish Government resources. Should the Scottish Ministers determine in future to capitalise the Bank beyond the levels set out in the Financial Memorandum the Scottish Parliament will be able to scrutinise that determination through the Scottish Government's budget proposals to Parliament.

As part of its operational planning for the Bank, the Scottish Government state it has conducted indicative financial modelling to establish a profile of anticipated returns to the Bank on its investments. They anticipate that the Bank, if capitalised as proposed, should command a level of financial return sufficient to facilitate ongoing investment by the Bank at a level that can make a substantial difference to the Scottish economy.

As previously mentioned, Scottish Ministers have accordingly proposed that the Scottish Investment Bank, currently administered by Scottish Enterprise, be transferred to the Scottish National Investment Bank. It is also proposed to align the Scottish Growth Scheme and the SME Holding Fund within the Scottish National Investment Bank.

- Operational planning for the transfer of the Scottish Investment Bank, the Scottish Growth Scheme, and the SME Holding Fund to the Bank has commenced.

- Plans are still under development and as such **no costs, or projected revenues from these programmes, have been included in the modelling at this time**.

Wider capitalisation context

Scale of investment

The Implementation Plan [4] notes that £2 billion of capitalisation is consistent with other national investment banks globally.

> “ Review of international comparators indicates the level of public capitalisation typically ranges between 0.5% and 1.5% of GDP. In a Scottish context, £2bn broadly equates to 1.3% of GDP. ”

Two billion pounds broadly equates to 1.3% of annual Scottish GDP. Thus, it should be noted that this statement will be valid only when full capitalisation is achieved over a 10 year period.

Issuing bonds

The Implementation Plan [4] highlights that most successful national investment banks are able to leverage initial public capital by issuing bonds – thereby increasing the amount of funds available for investment in the economy. The ability to leverage relatively small amounts of public capital into a significant source of strategic and long-term finance is a key source of strength of national investment banks around the world. The Plan states that issuing bonds will be a longer term objective for the bank.

> “ In its early years this option will not be immediately available to the Bank, as it will take time to develop an investment portfolio and the track record that is necessary to issue its own bonds. But this should be an objective to provide the Bank with the full range of financing powers and flexibility that is required to play a major role in the economy in perpetuity. It is recognised that dispensation from HM Treasury would be required for the Bank to raise its own finance.”

In its current proposed format the Bank will not issue bonds or public shares. As set out in section 4 of the Bill, the Bank can only borrow from the Scottish Ministers. The Bank will lend solely to the private sector.

Operational and set up costs

This section looks at the costs for the establishment and operation of the Bank until the point at which it can cover its own operating costs, as set out in the Financial Memorandum.

The Financial Memorandum [20] outlines a number of costs a result of the work necessary to establish the Bank and to support it to become fully operational. These fall into the categories of:

- **costs associated with the Scottish Government Bank Programme** (*these relate to costs incurred within the Scottish Government in relation to the preparation and operational planning for the establishment of the Bank*)
- **set up costs for the Bank** (*these are one-off costs associated with establishment of the Bank as a new entity*)
- **ongoing costs associated with the Scottish Government sponsor unit** (*are costs incurred within the Scottish Government on an ongoing basis*)
- the **operating costs of the Bank** until the point at which the Bank is capable of covering its operating costs from its revenues.

Notes on the modelling assumptions:

- The estimates provided for the costs incurred in relation to the Scottish Government Bank Programme, the set-up costs for the Bank, and the Scottish Government sponsorship unit are *estimates based on planning conducted to date . The Financial Memorandum states that these will be refined as operational planning progresses*.
- The estimates on the contribution to the operating costs of the Bank once established has been *reached as a result of indicative financial modelling*. The model identifies a projected point at which the Bank will be capable of covering its operating costs from its revenues. The projected costs are the shortfall between the Bank's projected operating costs and revenue before it reaches this point.

Over the period 2018/19 to 2022/23, Table 3 shows set up and operating costs to the Scottish Administration of £49.9 million. The nature of these cost are detailed further in the remainder of this chapter.

Table 3: Operational and set up costs for the Scottish National Investment Bank

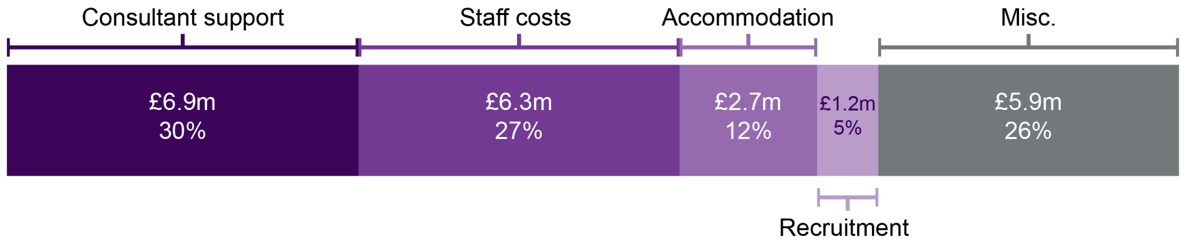
£m	2018/19	2019/20	2020/21	2021/22	2022/23	Total
Scottish Government Bank Programme	4.0	15.0	4.0	-	-	**23.0**
Set up costs for the Bank	-	-	5.0	-	-	**5.0**
Scottish Government sponsor unit	-	-	2.0	1.0	1.0	**4.0**
SG contribution to operating costs of the Bank	-	-	11.6	5.3	1.0	**17.9**
Total	**4.0**	**15.0**	**22.6**	**6.3**	**2.0**	**49.9**

Scottish Government Bank Programme

The Scottish Government Bank Programme costs for the preparation and operational planning for the establishment of the Bank will be incurred to the end of 2018/19, in 2019/20 and in 2020/21. The Financial Memorandum states that thereafter the Bank will be in operation and costs incurred within the Scottish Government will be as a result of the Scottish Government's role as a sponsor and shareholder in the Bank.

Figure 2 shows that consultancy support (30% of total Programme costs), staff costs (27%), and miscellaneous (26%) take up the highest proportions of the preparation and operational planning programme costs.

Figure 2: Cost of Scottish Government Bank Programme 2018/19 to 2020/21, £ million, total £23 million



Scottish Government, 2019[20]

Points of note on Programme costs.

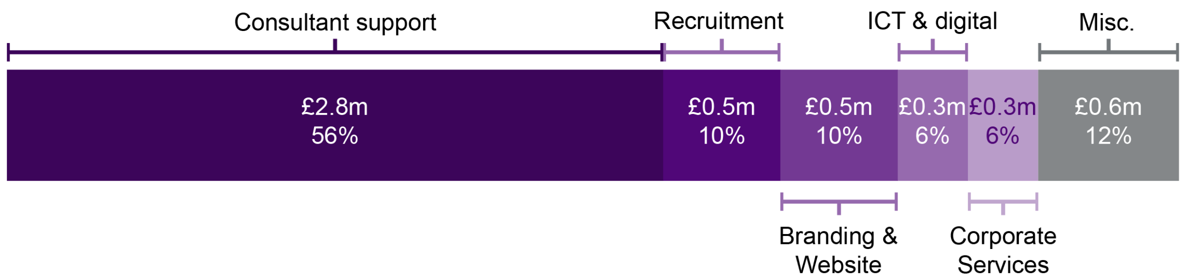
- The estimated miscellaneous costs include a contingency allocation. The contingency allocation in 2019/20 is larger than in other years to account for uncertainty in costs associated with integrating existing Scottish Government funding programmes into the Scottish Government Scottish National Investment Bank Programme.
- Staff costs are those associated with the Scottish Government civil servants working on the programme to establish the Bank.
- Accommodation costs include those associated with accommodating the Bank's programme team to alternative premises in Waverley Gate, Edinburgh.

Set up costs for the Bank

There will be a number of one-off set up costs associated with the establishment of the Scottish National Investment Bank in 2020/21. These costs are illustrated in Figure 3. Estate costs at £2.8 million (56% of the total set-up costs) make up the largest proportion.

These initial set up estimates have been adjusted for future inflation of 2% and an optimism bias has been included in line with HM Treasury Green Book recommendations. The Financial Memorandum notes that ***these estimates are expected to change over the course of 2019 as operational planning progresses*** .

Figure 3: One-off set up costs for the Scottish National Investment Bank 2020/21, £ million, total £5 million



Scottish Government, 2019[20]

Points of note on one-off set up costs.

- Recruitment costs relate to initial recruitment of staff to the Bank and includes the estimated costs for recruitment of the first Chair and the initial members of the Board, including the non-executives and the Chief Executive. These costs do not include the ongoing costs including remuneration.
- The ICT and digital cost estimates relate to one-off set up costs for ICT and digital systems for the Bank. It is not currently anticipated that the establishment of the Bank will require the development of new ICT projects. In some cases it may be suitable for the Bank to use existing Scottish Government systems.
- Estates costs covers the costs of securing and fitting out of office space for the Bank.
- Corporate services cost estimates cover the setting up of shared services for some of the corporate services of the Bank, such as procurement, HR, and internal audit.
- Miscellaneous cost estimates may include additional consultancy support or research costs.

Scottish Government sponsor unit

It is intended that the sponsor function for the Bank as a public body will include oversight of the Bank's activities, from the perspective of the Scottish Ministers as the sole shareholder. The Financial Memorandum includes costs of £4 million over the 3 year period 2020/21 to 2022/23. A higher estimate has been provided for costs associated with the sponsorship unit in 2020/21 than in subsequent years to reflect the transition in that financial year within the Scottish Government from the programme to establish the Bank to a sponsorship and shareholder role.

Table 4: Sponsor unit costs, 2020/21 to 2022/23, £ million, total £4 million

£m	2020/21	2021/22	2022/23	Total
Sponsor unit costs	2.0	1.0	1.0	4.0

Scottish Government, 2019[20]

Costs associated with the Scottish Government sponsorship unit are anticipated in particular to include: staffing and staff related costs, costs for external consultancy support, costs for research and costs associated with the Advisory Group. These and other costs will be identified in greater detail as the operational planning progresses.

An Advisory Group of up to 20 members will be established to provide the Scottish Ministers with advice on the Bank's objectives, conduct and performance. It will be resourced by the Scottish Government and is anticipated to meet 1-2 times a year. The establishment of an Advisory Group is not provided for in the Bill but will take place following the coming into force of the Bill. Costs per annum for the Advisory Group are estimated to range between £20,000 and £50,000 per annum

The Financial Memorandum only captures these until 2022/23. However, these are likely to be ongoing beyond 2022/23.

Contribution to operating costs of the Bank

The Bank is expected to become self-funding over the medium term. That is, that the Bank will cover its operating costs from the revenue returns made on its investments. Until the Bank is able to meet its operating costs from its revenue income, it will need to be supported by the Scottish Administration.

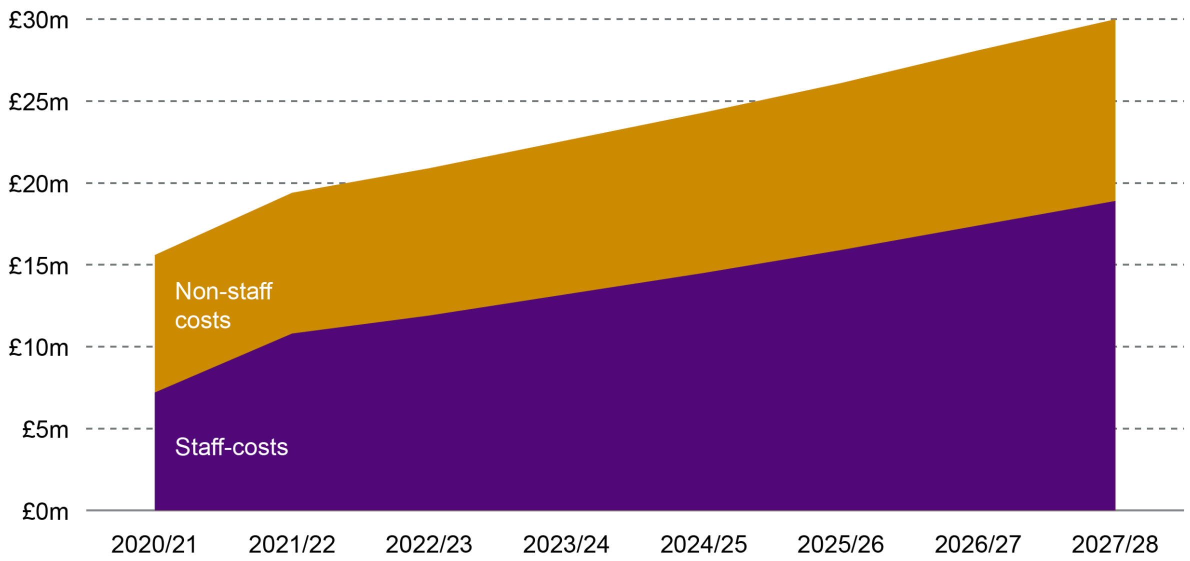
Projections of the estimated revenue to be generated by the Bank are based on the indicative financial modelling conducted to date by the Scottish Government, which is based on assumptions on the investments the Bank will make and their associated performance over time. At the time of writing, this indicative modelling work is not in the public domain. ***Please be aware the Scottish Government has caveated that these estimates are subject to further refinement as work on the Bank continues***.

- The Financial Memorandum notes that projected indicative overall operating costs for the Bank include an anticipated ratio of staff costs to non-staff costs based on the experience of comparable bodies (British Business Bank, Green Investment Bank, Development Bank of Wales). Comparison of the staff costs to non-staff costs of comparator bodies found that, on average, 63% of their operating costs were staff costs.

- The Implementation Plan estimated that the fully-capitalised Bank would require 100-150 staff members and that the Bank's annual operating costs would range from £20 million per annum to £30 million per annum. For the purposes of this Financial Memorandum, and to inform indicative financial modelling for the Bank, a mid-point estimate has been taken and the modelling has been based on estimated staff levels of 130 at the point at which the Bank is fully-capitalised (2027/28)

The Bank's operating costs are projected to gradually increase as the capitalisation of the Bank proceeds, as shown in Figure 4, and, accounting for inflation, are anticipated to meet the upper per annum estimate of £30 million in 2027/28; the point at which the Bank is fully capitalised.

Figure 4: Operating costs, 2020/21 to 2027/28, £ million, total £187 million



Scottish Government, 2019[20]

Non-staff operating costs are anticipated to include costs for: IT and digital, corporate services, consultant support, estates and marketing. The costs anticipated to be incurred in relation to each of these categories will depend on the identified needs of the Bank and the operating model it will implement.

- Costs for ICT and digital will include the costs of computers, mobile devices, ongoing website maintenance, printers, and basic IT programmes.
- Corporate services costs will include finance, human resources and payroll, procurement, and internal and external audit.
- The Bank is also anticipated to incur costs for procuring consultant support though the level of this will be contingent on the final operating model.
- The estates costs of the Bank will be contingent on the location chosen for the Bank, the type of property selected, and the type of procurement required (for example, lease versus build). Work during 2019 will determine where in Scotland the Bank should be located.
- There will also be additional miscellaneous costs incurred by the Bank including running and administration costs such as stationary, travel and subsistence, training and hospitality costs.

For comparison the operating costs of similar organisations in 2016/17, as noted in the Financial Memorandum, were:

- ***British Business Bank*** (144 staff) £22.65 million. £15.35 million (68%) of this related to staff costs, including Board costs of £275,000 for Chair and non-executive directors
- ***Development Bank of Wales*** (138 staff) £13.9 million. £7.7 million (55%) of this related to staff costs
- ***Green Investment Bank*** (120 staff) £32.09 million. £19.49 million (61%) of this related to staff costs, including Board costs of £320,000 for Chair and non-executive directors.

A self-funding bank

The Bill's Financial Memorandum states that further financial modelling will refine projections of the point at which the Bank will be able to meet the Implementation Plan's recommendation that it *“become self-funding over the medium term that is; the Bank covers its operating costs from investment returns.”*

The consultation document [21] related to the Bill notes that:

> “ Once the Bank is fully established the aim is for financial returns from its investment portfolio to at least meet its current and projected operating costs. This is not unrealistic; a net financial return of 2.5% on a £1 billion investment portfolio will be sufficient to fully cover operating costs of £25 million per annum. Any part of the financial return on investment that is not required either for re-investment by the Bank, or to help meet its operating costs (especially in the early years of the Bank's operations), could be returned to Ministers in the form of a dividend. The precise arrangements for this will be included in the Bank's governance documents.”

The indicative financial modelling conducted to date indicates that costs on the Scottish Administration as a result of the operation of the Bank until it is able to break-even are estimated to be £17.9 million in total in resource budget requirement. **The indicative financial modelling projects that the Bank will cover its operational costs from 2023/24.** The Scottish Government note that this indicative financial modelling is subject to further review and change.

Table 5: Operational costs to the Scottish Administration for the Scottish National Investment Bank, total £17.9 million

£m	2018/19	2019/20	2020/21	2021/22	2022/23	Total
SG contribution to operating costs of the Bank	-	-	11.6	5.3	1.0	**17.9**

Wider engagement related to finance

HM Treasury derogation

The Implementation Plan advises that Bank should reinvest its financial returns, both capital and interest, to create a self-sustaining, lasting institution with increasing influence on the Scottish economy. To achieve this ambition, the Bank needs to secure a dispensation from HM Treasury to have the flexibility to manage, retain and carry-forward cash balances over financial year-ends. This dispensation is required by the time the Bank is established.

Each year, the Scottish Government (SG) must operate within the budget limits set for capital and revenue by the Scottish Parliament. The money available for this comprises the budget settlement provided by the UK Government and the taxes raised within Scotland. This annuality of approach means that money must be spent in year; capital receipts, for example, have to be re-cycled into other projects in the same year.

Under the Fiscal Framework there is some limited flexibility at SG level to carry forward capital and revenue balances from one financial year to another through the Scotland Reserve. At present, the Reserve is capped in aggregate at £700m and the maximum which can be drawn down during the financial year is limited to £350m, of which capital is limited to £100m. SG should request dispensation from HM Treasury for the Bank to hold reserves and carry these over between financial years, out with the existing limits set for SG.

Source: [4]

Securing a different approach to management of year-end balances is not without precedent. HM Treasury agreed a different approach to the Green Investment Bank (prior to it privatisation) and to the British Business Bank, which has an on-going dispensation over and above Department for Business, Energy and Industrial Strategy's existing budget to invest public capital into SMEs. A similar arrangement is in place for Scottish housing associations, on a temporary basis.

As of April 2019, the Scottish Government is in contact with HM Treasury about the required derogation for the Bank, that would enable it to carry cash balances between financial years. In the most recent correspondence between the Cabinet Secretary for Finance, Economy and Fair Work and the Chief Secretary to the Treasury (27 February 2019) it was agreed that the Scottish Government and HM Treasury would continue to discuss the proposal for the Bank, and that officials should work towards potential solutions, including sharing of financial modelling. This is now in progress and further updates should be forthcoming in due course.

Securing permission from European Commission to comply with State Aid rules

It is intended that the majority of the Bank's products will be issued under commercial terms. However, in some circumstances the Bank may choose to offer products at sub-commercial rates, which may be deemed to be allowable state aid.

> State aid is a European Commission (EC) term which refers to forms of public assistance given on a discretionary basis which have the potential to distort competition and affect trade between Member States of the European Union. The state aid rules are set by the EC and comprise various articles of the Treaty on the Functioning of the European Union (TFEU), as well as regulations, frameworks and guidelines, which set out what aid can be given and under which circumstances.
>
> Source: [19]

It is anticipated that the Bank will be classified as a National Promotional Bank by the EC for the purposes of State Aid. The Commission has set out guidelines for the activities of NPBs and outline the process for the Commission to approve the Bank. This is necessary to allow the Bank to commence activity in its own right as a formal independent organisation.

As of April 2019, the Scottish Government is preparing a notification for State Aid approval for capitalisation of the Bank, in line with the Commission’s guidance. This will include a Pre-notification process, ahead of submitting a full notification later in the year. The Scottish Government is in close discussion with colleagues in the Scottish Government State Aid Unit and the UK Government Department for Business, Energy and Industrial Strategy to ensure they demonstrate compliance with all state aid regulations.

In the context of Brexit, the UK Government has indicated that its intended approach to State Aids will be similar, and the Scottish Government's intended approach to satisfying the legal requirements of state aid will not be substantively different in the short term. The notification will be considered by the European Commission until the UK has withdrawn from the EU and any Implementation Period is complete. In the event of a no-deal EU Exit, the Competition and Markets Authority will take on responsibility for State Aid approvals within the UK, and they will be the responsible authority post-Brexit.

Appendix A: Key documents for the Scottish National Investment Bank

Various reports and document types are mentioned in the Bill and the wider suite of supporting material. It should be noted that the wider suite of accompanying documents makes reference to other reports, strategies, or plans which have not all have been mentioned in the Bill. Across the Bill and the suite of accompanying material, it can be confusing to understand the range of documents/reports that will assist the operation of the Scottish National Investment Bank. Using all available supporting material, we have created the below list to help understanding.

Though we acknowledge here that the Scottish Government will be releasing further documents over the course of 2019, which will likely enhance understanding related to the below list. The time-frame for establishment of the Bank has meant development work is continuing in earnest during the Bill process.

- **Annual Performance Report** - the Bank must, at the end of each financial year, report to the Scottish Ministers on the performance of its investments. It is expected the report will be made publicly available in line with the principles of Open Government. However, the Scottish Government has included the flexibility in the legislation to accommodate the possibility that an annual report may include some commercially sensitive information that should remain between the Bank and the Scottish Ministers in their capacity as sole shareholder. In that case partial publication of the report (without the sensitive information) may be more appropriate. *[Referenced in Bill and Policy Memorandum]*

- **External Performance Review** (at least every 5 years) - Scottish Ministers must, at least every five years, appoint a person to review the performance of the Bank, and the performance of any subsidiaries of the Bank, and prepare a report of that review. The Scottish Ministers must lay a copy of that report before the Scottish Parliament, and make it publicly available. *[Referenced in Bill and Policy Memorandum]*

- **Investment Strategy** - it will be for the Bank to decide how it will direct its activities to respond to missions through its Investment Strategy. The Investment Strategy will be periodically revised and updated by the Board, taking account of any adjustments to the target rate of return and missions, as well as market conditions. Furthermore, the Board will also be responsible and accountable for ensuring that the Bank maintains an appropriate risk profile across its portfolio of investments and that the Bank delivers against the target rate of return set by the Scottish Ministers. The impact on portfolio risk will be considered by the Board when it agrees its Investment Strategy. *[Referenced in Policy Memorandum but not the Bill]*

- **Mission Report** - a mission report is a report explaining how the Bank intends to respond to the strategic missions that the Scottish Ministers have set for it. The Bank must send a mission report to the Scottish Ministers within 3 months of receiving a mission document from the Scottish Government or on the first day of each financial year, depending on timing sequences. This report may be issued as part of another document. *[Referenced in Bill and Policy Memorandum]*

- **Strategic Framework** - will be prepared by the Scottish Government which will set out: how the Bank, as a non-departmental public body, is intended to operate; its relationship with the Scottish Ministers; and the key roles and responsibilities which underpins this relationship. A final version of the Strategic Framework will be agreed in advance of the establishment of the Bank and made publicly available. *[Referenced in Policy Memorandum but not the Bill]*

- **Strategic Missions Document** - the Scottish Ministers set the Bank strategic missions by sending it a document describing the socio-economic challenges that the Bank is to seek to address. The Scottish Ministers may send the Bank a document modifying the document by which the strategic missions were set so as to set a new strategic mission for the Bank, modify a strategic mission, or bring a strategic mission to an end. The document must also be laid before the Scottish Parliament and made publicly available. The strategic missions set by the Scottish Ministers will complement the Bank's objects. *[Referenced in Bill and Policy Memorandum]*

- **Ethical Statement** - setting out principles which will guide its investment activity. This will be informed by the Equality Impact Assessment. *[Referenced in Policy Memorandum but not the Bill]*

Appendix B: Wider economic theory

Characteristics of national investment banks

Generally, the public interest mandate of national investment banks prohibits them from competing with commercial institutions, they cooperate closely with their private peers. In Germany for example, KfW's operating principle [5] , is based on co-financing loans, and its funding programmes work through the commercial banking branch network. In turn, its mandate means KfW is an important voice in economic policy debates within Germany. Of note is the reflected change of social goals within national investment banks, as they change over time, as shown by KfW's own history in Germany: in its early years it focused on reconstruction – but today it has the largest funding volume for environmental and climate protection projects of any development bank: 44% of the group's commitments.

Much of the Scottish Government's inspiration for a national investment bank draws on the academic work of Professor Mariana Mazzucato. Mazzucato highlights that over the course of the 20th century the role of national investment bank activities has moved from countercyclical lending to offset the 'credit crunch' during economic recessions (a countercyclical role) to funding for long-term projects, industrialization and capital development of the economy (a capital development role) to targeting investments in high-risk R&D, innovative start-ups, and lengthy innovations, areas that private capital has proved to be too short-termist and risk-averse to venture into (a venture capitalist role).

Changing role of national investment banks and patient finance

The roles performed by national investment banks have evolved over time in line with country-specific developments and challenges. Many national investment banks are now steering the path of investment towards specific 'missions' and are actively creating and shaping new markets, according to Mazzucato [12 6 7] . This has required patient, long-term, committed finance – typically over a 10-15 year return horizon which is beyond the investment horizon for conventional bank lending. An international comparison of national investment banks and patient finance [7] concluded the following lessons.

- The **overarching mandate is critical** to the role that investment banks play in their economies. Mandates are often set out in law or in Articles of Association, and often change and evolve over time.
- Some investment banks have been criticised on the b**asis of 'picking winners', 'crowding out' or funding large incumbent companies**. Part of the reason for this may lie in the **absence of monitoring and evaluation frameworks which adequately capture the dynamic outcomes of mission-oriented investments and the additionality generated by these institutions.**
    - Criticism can also be averted by avoiding focusing on firms of a specific size or in a specific sector ('picking winners'), and instead investing in firms that are willing to invest in innovation ('picking the willing').
- If a source of **finance proves to be volatile or unstable, or vulnerable to political pressures, then it can impair the ability of an investment bank to fulfil its mandate**.

- National investment banks must be able to strike the right balance between risk and reward, ensuring that **investments are structured across a risk-return spectrum so that lower risk investments help to cover higher risk ones**. Where success occurs, the bank should be able to reap some of the financial rewards in order to offset the inevitable failures.

It will be important that these lessons from international comparators are reflected in the planning and implementation of the proposed Scottish National Investment Bank.

Rationale for public intervention

The rationale for public sector intervention can be based on strategic objectives, improvements to existing policy, market failure or distributional objectives that the government wishes to meet. Generally, market failure theory is used by policy makers to inform the formulation and evaluation of public investments.

The HM Treasury Green Book *(central government guidance in policy appraisal and evaluation)* notes that market failure is where the market mechanism alone cannot achieve economic efficiency. Economic efficiency is achieved when nobody can be made better off without someone else being made worse off. Economic efficiency enhances social welfare by ensuring resources are allocated and used in the most productive manner possible. Commonly cited market failures include [13] :

- ***Public goods:*** Many aspects of the environment, for example the benefits of clean air, can be described as public goods. We can all enjoy clean air. It is difficult to actively exclude anyone from enjoying it (non-excludable in supply) and once provided, it largely doesn't matter how many people enjoy it (non-rival in demand). These features mean it is difficult for businesses to provide public goods and they are often provided (or in the case of the environment, protected) by government policies. A public good will be both non-rival and non-excludable.

- ***Imperfect information*** : Information is needed for markets to operate efficiently. Buyers need to know the quality of a good or service to judge the value it can provide. Sellers, lenders and investors need to know the reliability of a buyer, borrower or entrepreneur. This information must be available to all or there is 'asymmetry of information' which could lead to moral hazard or adverse selection.

- ***Externalities:*** These occur when an activity produces benefits or costs for others. Negative externalities are associated with, for example, passive or second-hand smoking. An individual may smoke tobacco indoors, in the presence of others, who inhale the tobacco smoke and damage their health. The smoker imposes an external cost on others, which would not be accounted for in the price of cigarettes without government intervention.

It is the existence of these market failures that justify public spending on capital-intensive areas like infrastructure, uncertain high-risk basic research (a typical public good) and innovation, financing of risky small firms (whose real 'quality' as borrowers is unknown to the investor), or investments in technologies that help to internalise negative externalities.

In Mazzucato's 2014 paper [6] it discusses how this market failure justification for public intervention and the associated evaluation toolkit has placed national investment banks under increased scrutiny and, in some cases, criticism, because any role beyond fixing market failures is seen as unjustified. Mazzucato believes that the fundamental problem is that the market failure perspective is based on a strong assumption: that markets are 'efficient' by default, so that public intervention should only aim to correct 'inefficiencies' in order to bring markets back to . Her paper [6] states that this perspective ignores the role that the state has played from the beginning of capitalism in shaping and creating markets. Furthermore, the market failure framework does not capture how, in countries that have been successful in achieving 'smart' (innovation-led) growth, the breadth of such public investments has been driven by broad 'missionoriented' justifications, such as those that drove investments by NASA, DARPA , etc.

Beyond market failure theory

Currently, the analytical frameworks used by governments to evaluate policy assume that government interventions are mainly concerned with correcting 'market failures' [12] .

Traditionally, the role of the state could be thought of as solving market and wider system failures. The changing activities of national investment banks extend beyond the correction of market failure to making strategic investments, which focus on solving societal challenges. Mazzacato believes that by doing so national investment banks have helped to rebalance the economies of their countries, reinvigorating the industrial base and developing transformative innovation [18] . Mazzucato believes there is a strong and clear argument that public investment is essential not only for fixing market failures, but for actively creating and shaping new sectors and driving innovation targeted at particular social and environmental objectives.

The proposed activities of the Scottish National Investment Bank go beyond a classic market failure correcting role to include a mission-orientated role to make strategic investments, which focus on solving Scottish societal challenges. Given that current analytical frameworks used by governments to appraise and evaluate policy assume that government interventions are mainly concerned with correcting market failures (for example see The Green Book [13]), it is valid to question from the outset how the Scottish Government will be adapting appraisal, evaluation, and monitoring tools in relation to the Bank.

Framework approach to missions

UCL Institute for Innovation and Public Purpose has developed an overview of a mission-oriented framework, and how it can be applied to the Scottish National Investment Bank. The framework document [12] states the 21st century is becoming increasingly defined by the need to respond to major social, environmental and economic challenges. Sometimes referred to as 'grand challenges', these include environmental threats like climate change, as well as demographic, health and wellbeing concerns

The Bank will have a 'mission-oriented' approach steering its investments.This involves picking the problems and helping any organisation (across the public sector, private sector, third sector, and across all manufacturing and services) that are willing to engage with the investments and activities that such challenges require. In other words, they require picking the 'willing', not picking the 'winners'.

Mission principles and criteria

The framework [12] advises that missions should be broad enough to engage the public and attract cross-sectoral investment; and remain focused enough to involve industry and achieve measurable success. By setting the direction for a solution, missions do not specify how to achieve success. Rather, they stimulate the development of a range of different solutions to achieve the objective. The framework states that mission-oriented policy is underpinned by a number of key principles:

- picking the problem, not sectors
- focusing on societal relevance: all missions should have societal relevance for a large section of Scottish citizens
- no ‘one size fits all’: missions come in different shapes and sizes
- fostering experimentation: missions must be chosen, yet their success will depend on the bottom-up processes that nurture innovation while ‘getting there’. A culture of experimentation and risk-taking is a crucial element in the philosophy of missions.

Missions should fulfil the following key criteria.

- A clear direction: missions should be broad enough to engage the public and attract cross-sectoral interest; and remain focused enough to involve industry and achieve measurable success.
- Targeted, measurable and time-bound: missions need to be very clearly framed. They need a specific target that can either be formulated in binary ways (as clearly as whether man has reached the moon and returned back safely) or quantified.
- Ambitious but realistic: setting missions unrealistically high will result in a lack of buy-in, while setting the objective too low will not incentivise activity.
- Cross-disciplinary, cross-sectoral: missions need to be chosen to address clear challenges that stimulate the private sector to invest where it would not have otherwise invested (“additionality”).
- Multiple bottom-up solutions: missions should not be achievable by a single development path, or by a single technology. They must be open to being addressed by different types of solutions.

Appendix C: Glossary

- **Additionality:** The extent to which investment takes place at all, on a larger scale, earlier or within a specific designated area or target group as a result of the Banks' intervention. The additional impact of the Bank's interventions is therefore the difference between the reference case position (what would happen anyway/ deadweight) and the position if the Bank's intervention option was implemented

- **Counter-cyclical**: A counter-cyclical policy takes the opposite approach: for example reducing spending and raising taxes during a boom period, and increasing spending and cutting taxes during a recession.

- **Crowd-in:** An economic principle in which private investment increases as debt-financed government spending increases. This is caused by government spending boosting the demand for goods, which in turn increases private demand for new output sources, such as factories.

- **Crowd-out:** This is a phenomenon that occurs when increased government involvement in a sector of the market economy substantially affects the remainder of the market, either on the supply or demand side of the market. The general definition of crowding-out is when government spending in an equilibrium economy pushes out private investment by producing disincentive effects.

- **Entrenched articles:** These are additional clauses in articles of association to make certain provisions more difficult to change than passing a special resolution. Any clause that requires more than a special resolution to be amended is known as an ‘entrenched provision’ under the Companies Act 2006 (Section 22). More details are available from https://www.legislation.gov.uk/ukpga/2006/46/section/22

- **Financial transactions:** These are a form of capital budget allocated by HM Treasury to the Scottish Government which can only be used for the provision of loans or equity investment beyond the public sector and cannot be used to fund public services. Financial Transactions facilities have to be repaid to HM Treasury in future years.

- **Leverage:** In the context of the Bank, this is the extent to which the Bank's funding can leverage in other sources of funding, such as private funding.

- **Macro-economic conditions**: Economic factors that influence the state of the whole economy, such as changes in employment levels, gross domestic product (GDP), and prices (deflation or inflation).

- **Market failure:** Market failure is the economic situation defined by an inefficient distribution of goods and services in the free market. Market failure can occur due to a variety of reasons, such as monopoly (higher prices and less output), negative externalities (over-consumed) and public goods (usually not provided in a free market).

- **Mezzanine debt**: This is a capital resource that sits between (less risky) senior debt and (higher risk) equity that has both debt and equity features. Companies use mezzanine financing to achieve goals that require capital beyond what senior lenders will extend. It is a patient source of financing that enables businesses to accomplish their goals for growth, whether it is building a larger production facility or accomplishing an acquisition that can't be completed with all senior financing.

- **Micro-loan finance**: Broadly this refers to the provision of loans of between £500-£25,000 to micro and small start-up and growing businesses. This type of finance tends to have no administration or early repayment fees.

- **Multi-criteria analysis:** This is a general framework for supporting complex decision-making situations with multiple and often conflicting objectives that stakeholders groups and/or decision-makers value differently. It tends to be a two-stage decision procedure. The first stage identifies a set of goals or objectives and then seeks to identify the trade-offs between those objectives for different policies or for different ways of achieving a given policy. The second stage seeks to identify the "best" policy by attaching weights (scores) to the various objectives.

- **Negative externalities**: These occur when production and/or consumption impose external costs on third parties outside of the market for which no appropriate compensation is paid. This causes social costs to exceed private costs. Common examples include congestion and pollution.

- **Parri passu:** This is a latin term that means "at an equal rate or pace." The term is often used in venture capital.

- **Patient capital:** This is long term capital where the investor is willing to make a financial investment in a business with no expectation of turning a quick profit. Often the investor is willing to forgo an immediate return in anticipation of more substantial returns down the road.

- **Senior debt**: This is money owed by a company that has first claims on a company's cash flows. It is more secure than any other debt such as subordinated debt (also known as junior debt) because senior debt is usually collateralised by assets. This means the lender is granted a first lien claim on the company's property, plant or equipment in the event that the company fails to fulfill its repayment obligations.

- **State aid**: This is any advantage granted by public authorities through state resources on a selective basis to any organisations that could potentially distort competition and trade in the European Union (EU). The definition of state aid is very broad because 'an advantage' can take many forms. It is anything which an undertaking (an organisation engaged in economic activity) could not get on the open market.

- **Venture capital**: A form of financing that is provided by firms or funds to small, early-stage, emerging firms that are deemed to have high growth potential, or which have demonstrated high growth. The main difference between private equity and venture capital comes down to the age of the company. Private equity will typically invest in a mature company, one which has been in operation for many years, if not decades. Venture capital by contrast will invest in new companies, many, if not most, of which will not yet be making a profit, but which have a disruptive business offering with the potential of very strong growth.

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