

## SCOTTISH NATIONAL INVESTMENT BANK RESPONSE

- › As the Committee will be aware the Royal Society of Edinburgh (RSE) has been engaged with the Scottish Government and key stakeholders throughout the process of development of the Scottish National Investment Bank (the Bank).
- › In our engagement the Society produced a response to the Scottish Government consultation on their initial proposals for the Bank in 2017. This was followed with direct engagement with government officials and stakeholders, through roundtable discussions with officials ahead of our response in 2018. The Society engaged further with the Scottish Government with discussions focusing on the future governance arrangements of the Bank.
- › The RSE has consistently made clear our concerns around certain aspects of the development of the Bank and what considerations need to be taken into account. We feel that our concerns and considerations have been listened to; and understand that these will be considered further in the development of the Strategic Framework. However, this inquiry presents an opportunity to reiterate some concerns and considerations to enable the Committee to effectively scrutinise the proposals and to consider if any changes or additions to the legislation are required at this juncture.
- › In principle, the Society is extremely supportive of the development of the Bank and believes that the proposed set up of the Bank as a PLC is the most sensible way forward. While we support the concept of mission-led funding, this does introduce a number of complexities. It is recommended that the focus on missions be phased in over a number of years, while the Bank's staff, and all involved, gain experience on how best to engage with missions while continuing to meet other obligations, including any requirement for a financial return. In the initial phase of the Bank's operation one appropriate and achievable mission could be to identify gaps in suitable finance available from other sources and to stimulate demand to ensure that the market is ready for the Bank's investment.
- › Not all the key characteristics of the Bank should be transferred from other examples of national investment banks across the globe. Each such national bank is inherently different, depending upon where they are operating and with what objectives. Instead the Bank's characteristics should take full account of the activities of other providers of finance in Scotland and the UK and be as closely related as possible to relevant aspects of the Scottish economy.
- › The Society still has concerns on the governance structure of the Bank, as there remains a significant risk of undue interference in the operation of the Bank from either the proposed Advisory Group and/ or Ministers. Additionally, the capitalisation of the Bank is likely to prove low if the Scottish Government wishes to focus from the outset on more than one mission, with substantial demand for funds. The day-to-day running costs of the Bank appear high, with the aim to breakeven in 2023/24 very ambitious.

# Summary

## Introduction

- 1 The Society has welcomed the proposals from the Scottish Government for the development of the Bank since they were first introduced in 2017. Our support for these proposals was reflected in both our 2017 and 2018 responses.<sup>1, 2</sup> Both responses and this response have been facilitated through the work of our Economy and Enterprise Committee which is now Chaired by Professor Andrew Porter with Professor Jeremy Peat as Acting and then Deputy Chair. The Committee brings together Fellows and other informed stakeholders with backgrounds in business, public sector, economics and finance.
- 2 Since producing our initial response in 2017 the Society has remained engaged with the relevant Scottish Government officials. Meetings have been held with the Economic Unit and the Bank's development team, in the form of direct and roundtable discussions, related to our concerns and considerations.
- 3 The Committee has previously examined the supply of capital to the SME base in Scotland;<sup>3</sup> this highlighted the gaps in the market and the low level of business investment in Scotland. We are not aware that there has been any significant improvement since that report, and it is hoped that the Bank could help to increase levels of investment and hence productivity. We see these objectives as critical for the future welfare of the Scottish economy.
- 4 In our responses to Government in 2017 and 2018 we welcomed the proposals and supported the key concept of the Bank to help drive business investment and improve productivity in Scotland. However, we have noted concerns with specific areas of the proposals which need to be addressed before the Bank becomes operational.
- 5 These concerns are around areas such as the number of objectives from the 'mission-oriented' approach; the risk of duplication of work by organisations like the British Business Bank (BBB) and ensuring wherever possible that the activities financed are 'additional'; the need to stimulate demand, and governance arrangements.

## Questions

*What are the advantages or otherwise in establishing the Bank as a public limited company?*

- 6 Our response in 2018 noted our support for the development of the Bank as a public limited company (PLC) over the other proposed models. This is the model under which the BBB operates and provides the most advantages to a publicly owned investment bank.
- 7 An advantage of the PLC model is that the corporate governance framework, whilst by no means perfect, is tried and tested. It is a framework with which the vast majority of individuals who might join the Bank (either as an executive or non-executive) are familiar and understand. Additionally, large numbers of organisations that will seek to engage with the Bank will be familiar with these arrangements. This approach will be far better than adopting a bespoke novel framework.
- 8 By adopting this model, the Bank will be required to comply with UK Companies Legislation on transparency and accountability. Transparency will be important, and it is expected that the Bank will comply with corporate disclosure by means of its Annual Report, which will be presented to the Scottish Parliament and enter the public domain. Adopting this framework would also afford the opportunity in due course of external investment into the Bank, e.g. by way of private equity investment or issuing tradeable bonds.
- 9 A concern around this model is that there is the potential for a repeat of the story with the Green Investment Bank, which saw it acquired by an international finance organisation which will be less inclined to pursue mission-oriented investment. However, the Bill addresses this issue specifically to prevent that eventuality.

<sup>1</sup> Royal Society of Edinburgh, November 2017, 'Scottish National Investment Bank'. URL: <https://www.rse.org.uk/advice-papers/scottish-national-investment-bank/>

<sup>2</sup> Royal Society of Edinburgh, November 2018, 'Scottish National Investment Bank'. URL: <https://www.rse.org.uk/advice-papers/revision-scottish-national-investment-bank/>

<sup>3</sup> The Royal Society of Edinburgh, 2014, 'The Supply of Growth Capital for Emerging High-Potential Companies in Scotland', URL: <https://www.rse.org.uk/advice-papers/the-supply-of-growth-capital-for-emerging-high-potential-companies-in-scotland/>

*What in your view are the fundamental characteristics of a national investment bank?*

- 10** The RSE would raise concern around the perceived intention to carbon copy certain aspects from other national investment banks into the Bank. In the initial proposals, examples around KfW (the German investment bank) were made. The scale and experience of the KfW is significant but it is not the most suitable example for the Bank. While international comparisons are useful to learn from, it must be understood that all national investment banks are different, with aspects adopted deemed to be relevant to key aspects of the economy of the specific nation concerned. The new Scottish Bank's key characteristics should closely reflect aspects of relevant components of the Scottish economy.
- 11** It is understood that the Scottish Government will favour the route of mission-oriented funding as portrayed by Professor Marianna Mazzucato.<sup>4</sup> Therefore, it will be expected that one of the key characteristics of the Bank will be mission-oriented finance. The RSE supports the concept of mission-oriented finance, and notes the key objectives of economic policy in Scotland. However, mission-oriented finance will be complex to introduce, operate and evaluate. Therefore, we would encourage a considered and phased approach, starting with one key mission and only expanding the number of missions as all involved gain experience. It will be particularly critical for the Bank to have a narrow focus in its opening years. We note that the missions referred to in documentation will tend to involve longer term investments – requiring 'patient' capital. Operating to help to achieve such missions will consequently involve a lower rate of financial return, at least in the early years. The Bank and Government will need to agree how to marry such mission-oriented funding with the presumed requirement to achieve a financial return and the fact that public sector resources are inevitably scarce. The Bank should have some operational flexibility for it to determine an appropriate balance between missions and other areas of the general remit. This would be most helpful for management of the Bank.
- 12** In the context of the Scottish economy, it would be expected that a fundamental characteristic should be the ability to provide advice and raise awareness to businesses which would help to increase the demand for capital. As stated in previous responses, the supply of capital in Scotland is increasing with more private sector and other organisations, such as the BBB, providing more capital into the market. Despite this investment is still low and this points to the critical importance of a lack of demand in the market, doubtless for a range of reasons. A clear gap in the market, where demand is low, is companies investing to scale up. If the Bank does not help stimulate demand – both directly and/or working with others – for capital, particularly where there are gaps, then it will be particularly difficult for it to achieve its main objective of stimulating investment and enhancing productivity.
- 13** The BBB mission is to 'help drive economic growth by making finance markets work better for smaller businesses wherever they are in the UK and wherever they are on their business journey'.<sup>5</sup> This is a succinct and well-defined mission and an area which has been proposed for the Bank's involvement. Whilst there will be scope for more than one operator seeking to work in this area, the Bank must be aware that having similar activity to the other institutions like BBB could lead to a notable risk of the duplication of work and misuse of scarce resources. Therefore, the Bank should be encouraged to work closely with the BBB to minimise any possible risk.
- 14** We expect that a key characteristic of the Bank will be its need for high level expertise in a number of areas. Recruitment of the appropriate staff at all levels will be critical. Starting off with a range of missions would mean a requirement for a diverse range of high-level expertise, adding once more to complexities while the Bank is getting up and running.

<sup>4</sup> Mazzucato, M., Macfarlane, L., 'A Mission-Oriented Framework for the Scottish National Investment Bank' March 2019, University College London.

<sup>5</sup> British Business Bank, 2018, 'Shared Values and Mission'.

- 15** It is difficult to answer this with complete confidence as there is uncertainty over what and how many missions there will be. Additionally, as the level of capitalisation will be decided on a yearly allocation basis much will depend on the political context and the decisions by the Scottish Parliament.
- 16** However, a concern over the level of capitalisation is that it is too low for the number of potential missions the Bank could have. The first stage of capitalisation of £2 billion over 10 years (200m a year) is not enough to provide investment across three or four missions – such as demographic issues and/ or transition to low carbon economy - which are significant in scale. We understand that this could lead to a push for an increase in the capitalisation of the Bank and would caution against this due to the current level of demand (see Paragraph 12) – at least until the Bank is fully ready to become closely involved in more than one form of mission-oriented finance.
- 17** The Bank will need to provide patient capital for whichever missions are chosen. Therefore, regarding the capitalisation of the Bank, it must be recognised that continuing input of patient capital will be needed for several years to produce financial returns and business growth. The capitalisation of the Bank must reflect this. Moreover, we would recommend that in the distribution of patient capital the Scottish Government consider ways of how investments will unlock other sources of capital.
- 18** In Chapter 58 of the financial memorandum the Scottish Government states, ‘The indicative financial modelling projects that the Bank will cover its operational costs from 2023/24. The indicative financial modelling is subject to further review and change.’ This timeline for the rate of return to breakeven appears too short and it is not clear whether it is on an accounting or cash basis which could be quite different for an entity of this nature. This will require ‘quick wins’ from investments which is likely to be in opposition to the overall ‘patient capital’ approach. More information is due to be published soon by the Scottish Government, which will provide more information on the operating costs and indicative financial modelling.

*What is your view on the proposed costs in the set up and day-to-day running of the Bank?*

- 19** The RSE understand the reasoning behind using the examples of the BBB and the Development Bank of Wales to help to propose the costs in set up and day-to-day running of the Bank. This approach makes sense if the number of missions that the Bank will focus on are narrowed down.
- 20** However, there are lessons to be learned from the private sector and we would recommend that the Scottish Government examine other models within the private sector to help estimate the costs of set up and day-to-day running of the Bank. In some instances, private sector organisations may operate with fewer staff, but still deliver significant outputs. However, we do understand that the complexity of the objectives of the Bank does support the case for more staff than in some private entities.
- 21** Similar to our answers on the key characteristics, the RSE would highlight that there is not enough information on this area as it will depend on the decisions of the Scottish Government and Parliament. However, we would raise concern over the proposed costs on the day-to-day running of the Bank. The prospective annual operating costs of at least £25 million to control an investment fund of £200m appears very high.
- 22** One specific area that appears to be disproportionate is the arrangements and cost of the Scottish Government Sponsorship Unit. A potential cost of £4 million with 40 people appears too high in staff numbers and cost. For the Bank the RSE would encourage the Scottish Government to look at examples within the private sector in which companies hire fewer people using less money but ensuring a provision of a high standard of expertise. We would emphasise the high levels of expertise and experience that the Bank will require.

*What governance arrangements ought to be in place?*

- 23** The RSE has already made clear our concerns and considerations on the governance arrangements of the Bank and for greater detail on these we would direct the Committee to our 2017 and 2018 response. Despite this we would like to use this opportunity to reiterate a number of concerns, to ensure that these are addressed within the process of parliamentary scrutiny.
- 24** One of the main concerns is the role of the proposed Advisory Group and how much influence it will have. We believe that unless its role is carefully specified and constrained, the risk of this Group clashing with the Board of the Bank is high. It might also tend to increase the risk of inappropriate political interference from Ministers. We would strongly recommend that the Chair of any Advisory Group should not be on the Board of the Bank.
- 25** The Society would also strongly advise against giving the Advisory Group any significant scope for influence on the direction of the Bank. The Group should provide ideas on missions or objectives, but it should be the final decision of Ministers in cooperation with the Bank through the CEO and the Board. We welcome the indication that annual and corporate plans will not need to be approved by Ministers and would recommend that this is not changed. This should help to guarantee that the Bank is operationally independent.
- 26** To ensure the work of the Bank is aligned with the work of other agencies, particularly the three economic development agencies, we suggest that the Chair of the Strategic Board for Enterprise and Skills agencies should be on the Advisory Group.
- 27** We appreciate that the appointment of the Chair of the Board and other Board members will go through the process of a Public Appointments Panel with the nominated candidate being approved by Ministers. The panel should include stakeholders who have a wide experience of operating in this sector and be chaired by a senior figure who would command the respect of applicants and Ministers. When the Chair is appointed,

the invitation should be distributed under the title of the Scottish National Investment Bank PLC and signed by the Chair of the Public Appointments Panel, rather than Scottish Government and the Minister. This approach would meet the need of Ministers but would give the appointee the sense of independence the Chair should have under good corporate governance principles.

- 28** Through this process we recommend that the Chair, after appointment, sits on the recruitment panel for Non-Executive Board members who will then be agreed by Ministers. The Chief Executive Officer and other Executive Directors such as the Chief Financial Officer should be appointed by the Board based on a job description and remuneration agreed by Ministers and using a panel selected by the Chair including other Directors and a representative for Ministers. Executives (other than Executive Directors), should be appointed by the Bank according to a process and delegated authorities determined by the Board. After the first appointments, we believe that the Bank's Board should have a Nominations Committee that will oversee any future Non-Executive and CEO appointments and advise the Board accordingly. At that stage Ministers will then only be approving Board recommendations.
- 29** The periodicity of the missions needs to be considered in the governance context as there is a high possibility that missions may be changed. All changes must be disclosed and be fully transparent, being reported to Parliament.

*How can we ensure the market is ready for the investment opportunities the Bank can offer?*

- 30** Stimulating demand will be important and should be an early focus of the Bank. As we have seen through the example of the Building Scotland Fund, if there is not enough demand then the outcomes of the Bank are effectively undermined.

**31** Therefore, the RSE would recommend that perhaps the one initial mission of the Bank should be efforts to develop a suitable – in scale and form – demand pipeline so that the Bank has investments ready when it becomes fully operational in 2020/21. This will require the Scottish Government to work with agencies and stakeholders to build a knowledge of the distribution channels and the gaps for investment. There is potential that there will be a flood of applications for investment and this may be overwhelming; so, having a team specifically focused on raising demand and awareness but also identifying where to invest will be important. Clarity of the division of responsibility between the Economic Development Agencies and the Bank will be important to avoid overlaps or gaps and signpost the market effectively. Market facing clarity, rather than public organisational simplicity, should be the aim.

*What ethical and equalities considerations do you think should inform the Bank's ethos and decision making?*

**32** As a PLC and with the Scottish Government as the sole shareholder, the Bank will be required to follow the Scottish Government guidelines on gender balance requirements for its Board and senior staff. Issues such as the gender pay gap will also need to be considered.

**33** We expect that, especially for mission-oriented activity, the Bank will focus on 'ethical investments' and this needs to be readily categorised. Ethical investments may focus on environmental or social issues. For instance, the Bank could use the Morgan Stanley Capital International Environmental, Social and Governance Index, (MSCI ESH), UN Global Compact, or the UN Principles of Responsible Investment which all support common approaches to ethical investing, helping institutions invest effectively in ethical areas.

*It is proposed that the Scottish Government will set the strategic direction of the Bank but the body itself decide on its investment approach. What is your view on this "mission-led" approach?*

**34** We fully agree that Government should set the Strategic Framework leaving the Bank to determine – and report upon – investments within that context. Additionally, as stated, while we do welcome the concept of mission-led, we do have concerns that there could be too many missions for the Bank to control and ultimately perform effectively.

**35** Whatever the missions are, the Bank should aim to provide patient capital and this needs to be over a lengthy period of return, particularly for investment in areas such as new low carbon technologies.

## Conclusion

**36** We remain supportive of the proposals to develop the Bank, but it must be established so as to be most likely to work to the benefit of Scotland. This means being established with the right skills and governance arrangements, making the right choices, and being aware of the scarcity of resources. We recognise that this is not easy, therefore it will be important to start with a narrow focus to slowly but surely build up expertise and experience. It will be the role of the Scottish Parliament to guarantee that these proposals are properly scrutinised.

### *Additional Information*

This Advice Paper has been signed off by the General Secretary of the RSE.

Any enquiries about this response should be addressed to Paul Stuart, Policy Advice Officer  
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