Scottish National Investment Bank

Implementation Plan

February 2018

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Foreword

“The greater danger for most of us is not that our aim is too high and we miss it, but that it is too low and we reach it.”

Michelangelo

It was an honour to be asked by the First Minister in the autumn of 2017 to lead an Advisory Group to make recommendations regarding the establishment of the Scottish National Investment Bank (“the Bank”). It has, moreover, been a privilege to work with the Advisory Group and the many who have supported the endeavour over the last few months. This report sets out my recommendations for consideration by Scottish Ministers.

We have engaged with an extensive and broad group of individuals and bodies in both the public and private sectors who have generously informed the development of the recommendations. Whilst specific views expressed have been, as one would expect, varied and in some cases opposed, there has been a strong consensus that there is an immediate and pressing need for the creation of the Bank. The development of similar institutions in many other countries around the world has been very effective in enabling economic progress.

Independent commentators view the immediate outlook for growth in the Scottish economy as languid at best, in part due to the material risks associated with the unfolding of Brexit and its consequences. It is paramount that we are bold in applying our resources with focus and ambition to underpin an inclusive, sustainable point of inflection for the economy. To do so with confidence we need the Bank to be ambitious – in terms of scale, scope and adaptability – as a necessary condition. But it will not be a sufficient one, since the unequivocal primary focus of the Bank will be the provision of debt and equity finance. In order to support the economic aspirations of the Scottish Government, the Bank must operate in close collaboration with other actors such as Scottish Enterprise to engender and support ambitious entrepreneurial behaviour in the Scottish economy. As we establish the Bank to provide additional financing coverage, we should recognise the success achieved in contiguous investment spheres. For example, recently published research underlines Scotland as home to the strongest regional angel network and Scottish Enterprise as the most active UK venture capital funder other than crowdfunders. Notwithstanding this success, the establishment of the Bank should be embraced as an opportunity to make access to finance and advisory support easier for SMEs in Scotland. In defining the purpose, vision and strategy for the Bank, it is vital to say what it is and what it is not. The Bank should be focused primarily on financing, albeit it will necessarily and appropriately offer support to its customers. It will not play a primary role in funding or application of grants, nor should the Bank compete with private financing such that there is a material risk of ‘crowding out’ private finance.

We have undertaken rigorous analysis, leaning on previous studies where possible, to determine where the Bank could act to complement existing private and public contributions to the economic well-being of Scotland. In familiar economic parlance we have sought to identify ‘market failure’ which undermines the potential for inclusive and socially beneficial economic growth. The expression ‘market failure’ has negative connotations and can be unhelpfully divisive. It is perhaps more progressive to think in terms of ‘risk appetite’. That is, existing financing sources focus on specific appetites for risk in terms of the nature of the investment and of its likely tenor. By adopting a strategic focus and risk appetite that is different, the Bank can fuel the economy through direct debt and equity investment, and by acting as a catalyst for private investment. Furthermore, many large deals involve foreign investors and our participation by share of deals – both by number and by value of investment – is low in comparison with other regions of the UK. The Bank should be capable of amplifying the voice of Scotland in this important regard.

The Bank will invest in a broad range of activities where it can make a complementary contribution to economic development. It will do so with the twin objectives of making a return in excess of the cost of capital at portfolio level and by achieving inclusive and social economic benefits. The Bank must be constructed in a manner which enables it to evolve over the long run in response to the changing economic needs of the nation. Equally, at every stage of its development – and perhaps most importantly at the outset – there must be uncompromising prioritisation of resources. An unwillingness to do so would, ineluctably, create an Achilles heel.

The areas identified as opportunities for the Bank fall into three broad categories:

- Support for early stage SME investment
- Scaling up SME investment
- Mission-led, patient long-term investment.

It is critical that the Bank ensures that SMEs have access to micro loan finance through the continuation of the existing activities of the SME Holding Fund. But we must also extend the offering to SMEs by providing short to medium-term loan finance – both senior and mezzanine debt – in the range of £100k to £2m. We should consider specifically – as is being done in Ireland – the opportunity and potential to deploy debt funds to support SMEs likely to be adversely affected by Brexit. The existing Scottish Investment Bank co-investment model for early stage equity investment up to £2m should be maintained. A real gap in the market which the Bank must serve, however, is the availability of financing to enable SMEs to scale up their business and the level of finance involved here is typically in the range of £1m to £10m, sometimes more. The Bank must be focused too on the opportunity for the transformative change required under the Programme for Government. These projects will often be defined as 'missions' and will enable key participants to coalesce around grand challenges such as the pursuit of decarbonisation or the adoption of artificial intelligence and machine learning, rather than being specific to traditional sector classifications. Through the provision of strategic, patient capital, the Bank will assume an enabling leadership role in industrial transformation, innovation and the shaping of markets.

We examined the merits of alternative ownership and governance structures. On ownership we concluded that Government ownership was clearly preferable to private ownership to ensure that the purpose of the Bank could be pursued consistently and with confidence in perpetuity. That conclusion was reached with an assumption that current constraints associated with such a structure would be relaxed to allow the Bank to deliver the desired impact in the medium and long-term. Needless to say, the level of capital and potential leverage will need to be commensurate with the intent of the Bank. Appropriate governance is essential to ensure that the institution operates effectively in a manner consistent with its purpose, strategy, and values. The approach set out in the recommendations would allow the Bank to operate independently under experienced, professional leadership, and within a framework agreed with the Scottish Government in relation to a strategic plan, a risk appetite and reserved matters. Scottish Ministers should also consider establishing an advisory group to advise Ministers in order to provide representation from a broad range of constituencies in the strategic reviews of the Bank. Further consideration should be given to the chair of this group having a place reserved on the Bank's Board.

There is an incontrovertible case for the establishment of a Scottish National Investment Bank. In order for it provide the required stimulus for the Scottish economy, it must have absolute clarity of purpose and values, it must have the right expertise and governance, and it must have the courage to prioritise rigorously. And it must do so with ambition.

Benny

Benny Higgins
February 2018

Executive summary

Introduction

The Scottish Government's 2017-18 Programme for Government[1] committed to establishing a Scottish National Investment Bank to boost Scotland's competitiveness and realise the Scottish Government's ambitions for the economy by providing patient capital to finance growth. This commitment was made on strong international evidence that national investment banks of scale can lead to a strong, positive impact on investment, innovation and long-term economic growth.

Such investment banks have played a key role in the economic development of many countries, and continue to do so around the world today. The roles performed by National Investment Banks ("NIBs") have evolved over time in line with country-specific developments and challenges. While the traditional functions of NIBs were in infrastructure investment and broad capital development, their activities have evolved over the course of the 20th century[2]. Through acting in concert with their governments and other public sector institutions, many NIBs are steering the path of investment towards specific 'missions' and are actively creating and shaping new markets. By making strategic investments and nurturing new industrial landscapes, they also focus on solving important societal challenges, and have helped other countries to rebalance domestic economies and reinvigorate their industrial base. This requires patient, long-term, committed finance – typically over a 10-15 year return horizon which is beyond the investment horizon for conventional bank lending.

If structured effectively, and with the appropriate attitude to risk and return, a Scottish National Investment Bank can also play a leading role driving growth and innovation, helping to transform Scotland's economy[3].

A new cornerstone institution in Scotland's economic landscape

The Programme for Government[4] builds on the 2015 Scotland's Economic Strategy[5] and sets out a clear economic approach which has at its heart a determination to establish an inclusive, fair, prosperous, innovative country, ready and willing to embrace the future. It acknowledges that the successful economies of the future will be resource efficient, low carbon and harness the power of technology, and illustrates a bold and forward-looking vision of a future-proofed, high-tech, low carbon Scottish economy.

It is apparent that we are now at a critical juncture, with a once in a generation opportunity for Scotland to grasp the potential that comes from technical advancement. To unlock such potential, the new Scottish National Investment Bank ("the Bank") will be a cornerstone institution in Scotland's economic architecture to help realise these possibilities. The Bank will need to be an innovative and forward looking institution and, as comparator institutions internationally have shown, have the ability to adapt to local market conditions and needs. Drawing from this strategic direction, 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 plans for the Bank must be bold, ambitious and based on financial innovation and market leadership. The Bank should be a catalyst for businesses with growth ambitions, supporting the acceleration and scaling up of the commercial deployment of innovation, technology

[1] Scottish Government (2017), "A Nation with Ambition: The Government's Programme for Scotland 2017-18 (http://www.gov.scot/programme2017)
[2] Mazzucato, M. and Penna, C. (2016), "Beyond market failures: the market creating and shaping roles of state investment banks", *Journal of Economic Policy Reform*, Volume 19 (issue 4): 305-326, (www.sussex.ac.uk/spru/documents/2014-21-swps-mazzucato-and-penna.pdf)
[3] Mazzucato, M. and Macfarlane, L, (2017), "Patient strategic finance: opportunities for investment-led growth in the UK". *UCL Institute for Innovation and Public Purpose, Working Paper Series* (IIPP 2017-05) www.ucl.ac.uk/bartlett/public-purpose/wp2017-05
[4] Scottish Government (2017), A Nation with Ambition: The Government's Programme for Scotland 2017-18 (http://www.gov.scot/programme2017)
[5] Scottish Government (2015), Scotland's Economic Strategy (https://beta.gov.scot/policies/economic-growth)

advances and R&D, and investing in cross-sectoral projects and initiatives that will help transform Scotland's local, regional and national economies. Where it identifies need, it will invest and lend on commercial terms, but with a different risk appetite to other financiers where required and appropriate, taking a longer term view on returns. The Bank will be an early investor in new and emerging market opportunities seeking to crowd-in investors and funders to help establish new financing markets aligned with the Scottish Government's priorities for the economy.

A vision for the Bank aligned to Scottish economic policy

The Bank should be an enduring institution, set-up as a public sector institution in perpetuity that aligns with the Scottish Government and its agencies to provide financing leadership. Close alignment between the Bank and government policy – both economic and social – should help create a powerful connection between policy, regulation and financing which can be co-ordinated for maximum impact[6].

The direction of policy, together with the activity and support of the Bank, will create confidence in the private sector to invest where previously they would not have done. This will enhance the effectiveness of the Scottish Government's interventions and allow a longer term view to be taken by business, investor and the Scottish Government itself.

Focus of activities

The Bank should develop financial products to help realise growth opportunities across the economy, with a particular focus on innovative and productive sectors. It should have the capability to provide capital across all stages of the business growth lifecycle and ensure that, where there are gaps or opportunities, it can address these through a range of financial products. Critically, it should focus activities on areas which can contribute most to the policy-driven missions identified by the Scottish Government.

Because innovation is highly uncertain and has long lead times, achieving smart, innovation-led growth requires not just any type of finance, but patient finance. The Bank should, therefore, provide access to long-term patient finance where need exists.

To build on the success of existing operations and the clear alignment with the Bank's agenda, the 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.

This consolidation will ensure a greater coherence for those firms looking for finance by simplifying the existing public sector landscape. Issues affecting the demand for finance, such as reluctance to take on equity funding or lack of knowledge on the funding options can be an inhibitor to growth, and the coherence of the public sector offer is an important part of addressing this. It will also ensure the efficiency of public sector activity in this area through enabling the Bank to best direct its capital across the existing financing activity and new activities, utilising existing channels to market and investor relationships. The full details of the integration and alignment should feature as an explicit strand of the plan to progress the Bank's set-up.

[6] Macfarlane, L. and Mazzucato, M. (2018), "State investment banks and patient finance: An international comparison", UCL Institute for Innovation and Public Purpose Working Paper, IIPP-WP 2018-01.

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 to achieve the mission-led objectives set by Scottish Ministers enabling businesses and the economy to flourish.

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.

Building on the existing supply of finance, the immediate areas of additional activity required for the Bank to deliver most impact are expected to be:

- **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.

The initial financial product range that the Bank should focus on is:

- 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 recently launched Brexit Loan Fund being 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.

It will be for the Bank itself to develop detailed product offerings. There should be a presumption, as with existing activity, that those offerings aim to maximise additionality (measured in financial, economic, social and environmental terms), but within the bounds of the Bank being financially self-sustainable.

Acting commercially, the Bank 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. 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.

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. As a Government backed investor the Bank will provide increased confidence to the private sector to co-invest as seen with SIB's existing investment activity.

The Bank will need the capability to make direct investments, especially for larger transformative projects which will take time and effort to develop the opportunities and financing solutions. This is an area where close co-ordination of effort will be required between the Bank, the Scottish Government and other public sector bodies.

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

A clear understanding of the remit of the Bank will be critical to its success, as will a focus on specific areas where it will operate. Several activities are excluded due to an inappropriate fit with the Bank's remit and/or for operational reasons. These include:

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

As the Bank will not be a deposit taking institution it will not require a banking licence. This enables the Bank to have much more flexibility over where and how it invests in the economy by not being bound by banking regulation.

Classification and capitalisation

The Bank should be set up as a limited company, wholly owned by the Scottish Government with an independent Board to oversee operations. This enables the Scottish Government to set up the Bank at arm's length and enables it to act more freely and flexibly in the market than a regulated bank in order to achieve the objectives set for it by Scottish Ministers. 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.

The Bank should be capitalised over time by the Scottish Government. An early commitment to this has been made by the Scottish Government in the 2018-19 Draft Budget with an undertaking to provide initial public capital of £340m for 2019-20 and 2020-21. The Draft Budget also 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, transfer to the Bank in 2019-20 when it is operating in interim or 'shadow' form, pre-incorporation.

To achieve a step change in the supply of finance, the target level of public capital for the Bank should be a minimum of £1bn over the first five years and a further £1bn over years 6 to 10 (this excludes the funding of the existing financing activities to be brought under the remit of the Bank). A public capitalisation at the level of £2bn – equating to around 1.3% of Scotland's GDP – is in line with international comparators.

The 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, there are three key milestone objectives:

- To secure a dispensation from HM Treasury to have the flexibility to manage, retain and carry-forward cash balances over financial year-ends. This is required by the time the Bank is established

- To be self-funding, meaning that the Bank covers its operating costs from investment returns. Given the longer term investment horizon of the proposed investment activities, this objective may not be achieved until the medium-term

- To be able to raise capital in its own right and no longer be reliant on capital advances from the Scottish Government to fund its investments. Further dispensation from HM Treasury will also be required for this.

Governance

The Bank's investment mandate should come from the Scottish Government via a Strategic Framework.

The Bank should have a Board, with the Chair of the Bank and Non-Executive Board Members appointed by Scottish Ministers, but it is envisaged that the Executive Management Team appointments will be made by the Board.

The structure of the Bank should enable it to enter into a range of activities to support economic growth in Scotland by providing targeted financing solutions. A 'Top-co' arrangement with a series of subsidiaries (for example, to enable co-investment funds) would be the most appropriate operating model to maximise the flexibility of the Bank's investment activities and private sector investment.

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.

Importantly, to augment the governance arrangements and ensure that the Bank has appropriate societal representation, the Scottish Government should assess the optimal means of ensuring effective representation with stakeholders and wider civic society. This report recommends establishing an advisory group as one option to achieve this with its purpose to advise the Scottish Government on the Strategic Framework, and with the Chair of this group having a place on the Bank's Board as a Non-Executive Director.

Transition

There are a number of key activities that need to take place in order for the Bank to be a fully operational, independently run, institution, including: passage of a Bill through the Scottish Parliament; agreeing the dispensation from HM Treasury; agreement of the operating model; integration of existing activities and people; and investment in additional people and systems. The Bank should be established as a legal entity and become fully active during 2020 following the legislative process.

To provide strategic direction to the transition process, a shadow Chair should be appointed as soon as possible in 2018 to oversee the project team formed to deliver the transition and establishment of the Bank. With a view to be operating in a shadow form in 2019, a shadow Board and interim Executive Management Team should also be appointed in advance to develop the initial Investment Strategy and Business Plan for 2019-20.

The work to establish the most effective operating model for the Bank should be agreed during 2018. This should include how it will assume responsibility for activities currently provided by others, allowing these skills and knowledge to be available to the Bank. 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. Being active as a shadow organisation in 2019 will provide a clear sign of progress and momentum.

Summary

The vision set out here for the new Bank is one with the scope and scale to be transformational to the Scottish economy. It will coalesce with the wider economic landscape around a number of critical missions helping Scotland to harness its full economic potential.

Recommendations

The recommendations set out within the Implementation Plan are summarised below.

No.	Recommendation
1	A national investment bank should be established for Scotland with a vision to "*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."*
2	The Bank's strategic priorities for investment should be centred on a core role of helping to address Scotland's economic priorities in an inclusive and ethical way.
3	This new, mission-led institution will actively create and shape markets. It will intervene in a variety of areas – to supporting early stage and smaller firms and larger scale innovative projects get access to investment, through to financing infrastructure where the private sector will not invest. The initial focus of the Bank should be: • Providing growth capital to ambitious and innovative companies – with the capability to support across the lifecycle of a company's need for capital. • Providing finance to support the projects and initiatives aimed at realising opportunities to transform the economy. The Implementation Plan sets out a range of financial products that the Bank should seek to develop to support this initial focus.
4	In addition to the supply of capital, 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 who provide a range of support services to companies, and with the Scottish Futures Trust in relation to its activities on infrastructure.
5	The Bank should aim to 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, complementing rather than crowding-out existing or potential investment.
6	The Bank should adopt a balanced portfolio approach across a range of potential products and asset types. Its target should be to achieve a positive financial return on its individual investments, and at a portfolio level which should be measured over at least a 10-15 year horizon, recognising the focus on investment in patient capital and transformative infrastructure.
7	Scottish Ministers should determine an appropriate basis for measuring the Bank's performance, taking into account the long-term nature of the investments and mission-orientated approach that's envisaged for the Bank. A balanced scorecard approach is required that reports on the financial performance as well as on economic impact over time, including social, environmental and ethical returns.
8	The Bank should seek to maximise leverage of private capital as appropriate, alongside its own investments. In doing so, it should adopt a flexible approach; it may be appropriate for the Bank to invest or lend directly alongside private sector investors through third party delivery agents or via external funds.
9	The Bank should build on current skills and experience successfully developed in Scotland, building on the track record of success, and creating a single point of delivery of financing support for business growth and innovation financing for transformational projects. A detailed review will be required in response to this recommendation in order to achieve the optimal operating model and ensure essential close interaction between the Bank and the enterprise agencies, including how to ensure co-ordination of funding, company relationships and financial readiness activities that will be provided by the agencies.
10	The Bank's activities should be aligned with the activities of the British Business Bank in Scotland, which may require establishing a strategy for alignment between both institutions.
11	The Bank should be established as a public body to ensure a continued focus on the Scottish economic strategy and alignment with a mission-based approach to investment. The form of public body should ensure maximum flexibility in how the Bank invests.

No.	Recommendation
12	Long term, mission-orientated investment requires a long-term capitalisation and funding commitment by the Scottish Government. The target level of initial capitalisation is £1bn for new activity, provided over the first five years followed by a further £1bn over years 6-10.
13	Three essential milestones should be set for implementation and successful operation of the Bank at the scale envisaged: • To be set-up with the flexibility to manage, retain and carry-forward cash balances over financial year-ends • To become self-funding over the medium term that is; the Bank covers its operating costs from investment returns • To be able to raise capital in its own right and no longer be reliant on capital advances from the Scottish Government to fund its investments.
14	As sole shareholder and sponsor of the Bank, Scottish Ministers will need to set the parameters within which the Bank should work. To do this Ministers should set a five year Strategic Framework for the Bank to respond to in its Investment Strategy and Business Plan. The reporting framework should ensure the highest standards of transparency and accountability.
15	The Bank should be administratively and operationally independent of Scottish Ministers. The Board should include a Chair and non-Executive members appointed by Scottish Ministers, and two Executive Directors in the shape of the Chief Executive Officer and Finance Director. There should be an appropriately experienced and professional Executive Management Team.
16	The Scottish Government should consider how best to consult with wider stakeholders on setting the Strategic Framework for the Bank to ensure that there is broad engagement with civic society on how the Bank is operating. This report recommends that an advisory group should be established whose membership comprises representatives from stakeholders and wider civic society. The group should advise Ministers on the Bank's Strategic Framework. The Chair of this advisory group could be on the main Bank Board as a Non-Executive Director.
17	The Bank should establish and operate to the highest standards of transparency, accountability and management of risk. This should be reflected in the reporting and accountability arrangements to be put in place, and in the formal governance arrangements of the Bank.
18	In setting up the Bank, Ministers should appoint an independent shadow Chair as soon as possible, to oversee the work of a project team responsible for the transition and set-up of the Bank. A shadow Board and interim Management Team should be put in place prior to the Bank operating in shadow form in 2019.
19	Scottish Ministers should concurrently confirm the Bank's initial missions and the first Strategic Framework, ensuring that the essential clearances and changes required are obtained from HM Treasury and others.
20	The Bank will need staff with the right mix of skills and experience to ensure its success and sustainability. The Scottish Government should ensure that the Bank can offer employment and remuneration terms which are sufficiently competitive to attract suitably skilled and experienced people.
21	The Bank should adopt a leadership role with regards to diversity and inclusiveness within its governance, operational arrangements and investment strategy.

The Implementation Plan set out overleaf provides detail behind each of the above recommendations.

The Scottish Government has prepared an analytical document of supporting evidence to support the findings set out in this Implementation Plan.

Abbreviations

Abbreviation	Detail
BBB	British Business Bank
BEIS	Department for Business, Energy and Industrial Strategy
BERD	Business Expenditure on Research and Development
BVCA	The British Private Equity and Venture Capital Association
CEA	Council of Economic Advisors
CEO	Chief Executive Officer
DBFM	Design, Build, Finance and Maintain
EIB	European Investment Bank
ERDF	European Regional Development Fund
EU	European Union
FCA	Financial Conduct Authority
GBER	General Block Exemption Regulation
GDP	Gross Domestic Product
GIB	Green Investment Bank
HM Treasury	Her Majesty's Treasury
IP	Implementation Plan
IRR	Internal Rate of Return
JESSICA	Joint European Support for Sustainable Investment in City Areas
MEOP	Market Economy Operator Principle
NDPB	Non-Departmental Public Body
NEDs	Non-Executive Directors
NHT	National Housing Trust
NIB	National Investment Bank
NPB	National Promotional Bank
OBR	Office for Budget Responsibility
OECD	Organisation for Economic Co-operation and Development
OMSE	Open Market Shared Equity scheme
ONS	Office for National Statistics
PWLB	Public Works Loan Board
REIF	Renewable Energy Investment Fund
R&D	Research and Development
SCF	Scottish Co-Investment Fund
SE	Scottish Enterprise
SEGCP	Scottish European Growth Co-investment Programme
SFC	Scottish Fiscal Commission
SFT	Scottish Futures Trust
SFTi	Scottish Futures Trust Investments Limited
SG	Scottish Government
SIB	Scottish Investment Bank
SME	Small or Medium Sized Enterprise
SPRUCE	The Scottish Partnership for Regeneration in Urban Centres
SVF	Scottish Venture Fund
The Bank	Scottish National Investment Bank
The Commission	The European Commission
UKEF	UK Export Finance

The opportunity of a Scottish National Investment Bank

1

National Investment Banks of scale are successful across the globe

National investment banks ("NIBs") play a key role in the economic development of many countries, with over 90 institutions existing across different countries and regions around the globe.[7]

In recent years, the more successful NIBs have taken on a new role as key domestic and global actors driving economic growth and innovation, particularly through addressing contemporary challenges such as climate change. By making strategic investments and nurturing new industrial landscapes, their focus on solving important societal challenges (a "mission-oriented" approach) has helped to rebalance their economies and reinvigorate the industrial base. These institutions act in concert with their governments and help achieve long-term objectives.

A mission-oriented approach to industrial policy has helped to determine the direction of growth by making strategic investments across many different sectors, and improving business expectations about future growth areas. This requires patient, long-term, committed finance – typically over 10-15 years which is beyond the investment horizon for conventional bank lending.

By developing new financial tools and working closely with public and private stakeholders NIBs can, if structured effectively and with the appropriate attitude to risk and return, play a leading role in driving growth, innovation and industrial transformation. By steering the path of innovation towards missions set by government, these NIBs are not just correcting issues in existing markets (a "market failure" approach in the common terminology), but are actively creating and shaping markets. They are enabling activity that otherwise would not take place.

A new cornerstone institution in Scotland's economic landscape

The modern era, with the unprecedented pace of technological change, is having huge economic, societal and environmental impacts across the globe. Governments and capital markets need to respond to these challenges in a new and co-ordinated way at a strategic level, including stimulating investment across sectors to address complex challenges.

There will be opportunities for business to capitalise on these changes, and first-mover advantages to those countries who mobilise resources most efficiently. Scotland is well placed to do this. It has a scale that facilitates collaboration, combined with the human and natural resources required to seize the economic opportunities of the future. Scotland has the potential to demonstrate global leadership on common challenges such as transitioning to a low carbon economy, population health and demographic change, as well as harnessing the powers of rapid technological development to provide benefits to all across society.

The new Scottish National Investment Bank ("the Bank") should be a cornerstone institution in Scotland's economic architecture to help realise these possibilities, building on the success of the Scottish Government's ("SG") current support mechanisms.

[7] Mazzucato, M. and Macfarlane, L. (2018), State Investment Banks: Selected International Case Studies which has been published by the Scottish Government alongside this Implementation Plan.

It should be set up to be an enduring institution that aligns with SG and its delivery agencies to provide critical economic leadership. By applying robust data analysis and developing evidence, it should respond to well-defined missions that are focused on solving important societal challenges. This will provide policymakers the opportunity to determine the direction of growth by facilitating strategic investments across many different sectors and nurturing new industrial landscapes, which the private sector can further develop.

Close alignment between the Bank, other public sector agencies and government should create a powerful connection between policy, regulation and financing which can be co-ordinated for maximum impact. The direction of policy (both economic and social) together with the activity and support of the Bank, will create confidence in the private sector to invest where previously they would not have done. This will enhance the effectiveness of SG's interventions and allow a longer term view to be taken by business, investor and SG itself.

A vision for the Bank aligned to Scottish economic policy

Scotland has a distinct economic policy environment with Scotland's Economic Strategy[8] establishing four key priorities for growing the economy. These priorities cover investing in people and infrastructure, fostering innovation, promoting Scotland internationally and inclusive growth – the notion that growth which combines increased prosperity with greater equality creates opportunities for all and distributes the benefits of increased prosperity fairly.

Scotland's Programme for Government builds on this. In its own words, it:

"…sets out a bold and forward-looking economic vision – sending a clear message to our people, businesses, schools, colleges and universities, and to the wider world: Scotland's ambition is to be the investor and the producer, not just a consumer, of the innovations that will shape the lives of our children and grandchildren.

We will seize the economic opportunities of tackling climate change, helping existing industries adapt to the future and using developments in data and digital technology to make our economy more competitive, productive, innovative, fair and profitable."

It is apparent that we are now at a critical juncture, with a once in a generation opportunity to grasp Scotland's competitive advantage which can deliver this potential. To unlock such potential, the Bank will need to be an innovative and forward looking institution and, as comparator institutions internationally have shown, will need to have the scope and scale to adapt to local market conditions and needs.

Drawing from this strategic direction, 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."

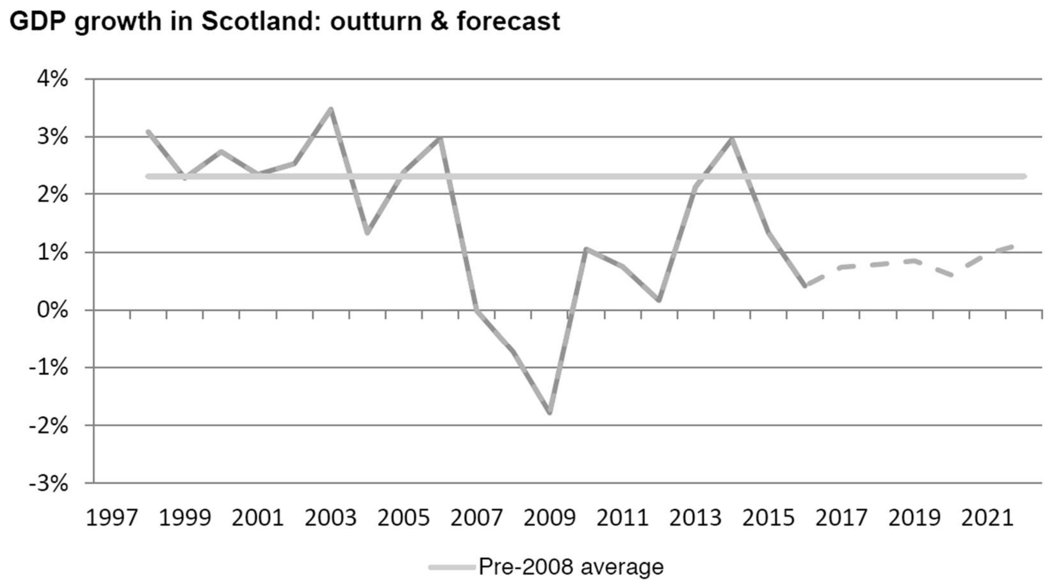
[8] Scottish Government (2015), Scotland's Economic Strategy (https://beta.gov.scot/policies/economic-growth)

The current economic outlook is challenging

The vision for the Bank is for a long-term cornerstone institution at the heart of the Scottish economy. It is useful to set this in the context of the current economic climate.

The current Scottish Fiscal Commission ("SFC") economic forecasts[9] are for modest growth over the period to 2021, below the pre-2008 long-term trend (see Figure 1). The forecast is partially driven by SFC assumptions about productivity growth in the Scottish economy and partly by the modelled impact of the UK leaving the European Union ("EU"). The Office of Budget Responsibility ("OBR") for the UK as a whole show a similar picture although they are more optimistic in their central projection[10].

Figure 1: GDP growth in Scotland: outturn and forecast



Source: Scottish Government (2017) Quarterly National Accounts Scotland Quarter 2 2017 (link), Scottish Fiscal Commission

The SFC has taken a more pessimistic view of the impact of Brexit than the OBR. The SFC take the view that EU migration will be significantly lower than recent trends and that there will be an adverse impact on trade. At the time of writing, the future relationship with the EU was unclear, but SG analysis published in January 2018[11] provides new evidence of the substantial costs resulting from lower economic growth and lower business investment opportunities in Scotland and the UK that will result from leaving a market in excess of 500 million people. Scotland's GDP could be as much as 8.5% (or £12.7 billion) lower by 2030 and business investment in Scotland could fall by up to 10.2% by 2030, compared to continued EU membership.

[9] Scottish Fiscal Commission (2017), Scotland's Economic and Fiscal Forecasts December 2017, (http://www.fiscalcommission.scot/publications/scotlands-economic-and-fiscal-forecasts/scotlands-economic-and-fiscal-forecasts-december-2017/)

[10] The SFC forecasts for Scotland are close to the 4th decile of the spread of OBR forecast variation. See Chart 1.4 of the Economic and Fiscal outlook; Office for Budget Responsibility (2017), Economic and fiscal outlook – November 2017, (http://obr.uk/efo/economic-fiscal-outlook-november-2017/) http://obr.uk/efo/economic-fiscal-outlook-november-2017/

[11] Scottish Government (2018), Scotland's place in Europe: people, jobs and investment, (https://beta.gov.scot/publications/scotlands-place-europe-people-jobs-investment/)

The potential economic benefit of establishing the Bank

SG's Council of Economic Advisers ("CEA") has previously set out the importance to Scotland's economic growth of supporting infrastructure development, providing finance for high growth businesses, and supporting strategic investments in innovation through a submission to the consultation on the Green Paper for the UK's Industrial Strategy[12]. The work of the CEA recognised the scale and scope of existing SG investment and intervention in infrastructure and business development, but also identified the potential for a Scottish National Investment Bank to support the delivery of long-term investment to boost economic development.

In particular, the CEA highlight a number of issues around patient capital which are fundamental to long-term growth, and where a NIB could stimulate stronger economic growth across Scotland. These include:

- **The need to achieve higher levels of long-term investment in SMEs**: High transaction costs and what are termed "information asymmetries" can lead to an under supply of finance for SMEs (a problem traditionally known as the 'Macmillan gap'). Both debt and equity providers tend to prefer the lower aggregate transaction costs of larger deals, and are reluctant to spend the extra time and cost to support some types of investment. It is also easier to invest in firms with longer track records and where returns are more predictable than newer firms, where returns are less certain and further in the future.

- **The need for improved innovation performance**: According to the European Commission's Regional Innovation Scoreboard, Scotland is classed as an innovation 'Follower'. It ranks around the middle of EU countries across a composite of innovation indicators. Scotland's overall expenditure on R&D as a percentage of GDP is low relative to comparator countries. Within this, Scotland performs particularly poorly in terms of Business Expenditure on R&D (BERD), ranking fifth amongst sixth comparator countries.

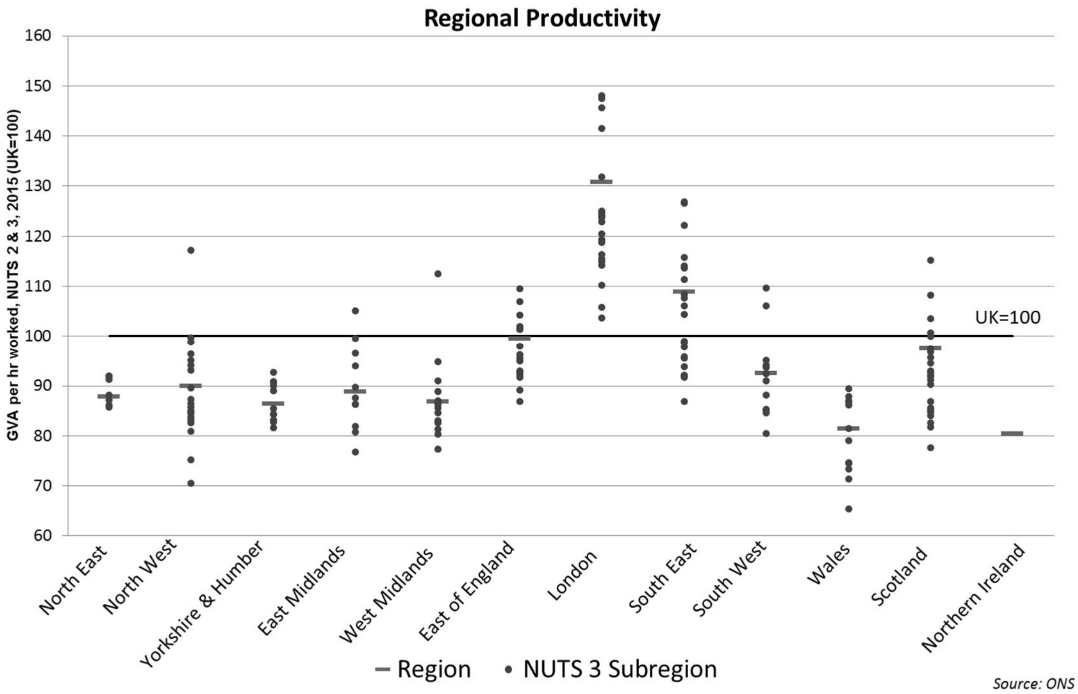
A further unique feature of the Scottish investment landscape lies in the success and volume of investment by universities and other academic institutions. In 2012, for example, Scotland's higher education R&D expenditure as a percentage of GDP was the fourth highest in the OECD, with half of Scotland's University research being assessed as world-leading or internationally excellent. This makes the relative lack of technology companies based in Scotland starker, and points to a missed opportunity to use the intellectual capital that Scotland has in abundance.

The CEA also focused on the support for patient capital within a devolved Scottish context, and the constraints within the current UK institutional arrangements. They specifically highlighted the persistent gap in the provision of microfinance, debt and early stage equity for small and medium enterprises, and growth capital in amounts up to £10m. In addition, the dependency on European funding sources was noted as significant in Scotland and highlights that Brexit could have significant implications for support for business development funding and infrastructure investment in the coming years.

In order to achieve its full potential and deliver the maximum level of economic benefit to Scotland, the operations of the Bank should be based on a deep and comprehensive understanding of the unique and varied characteristics of the Scottish economy. As with the strongest-performing NIBs elsewhere, it should establish a sharp and dedicated focus on the specific set of conditions which it faces. For example, we know there is significant variation in the industrial composition and productivity performance across – and within – UK regions. Productivity across the whole UK demonstrates significant variation, with London and the South East clearly outstripping other regions' performance (see Figure 2).

[12] Scottish Government (2017), Council of Economic Advisers: building our industrial strategy, (https://beta.gov.scot/publications/uk-government-green-paper-building-our-industrial-strategy/)

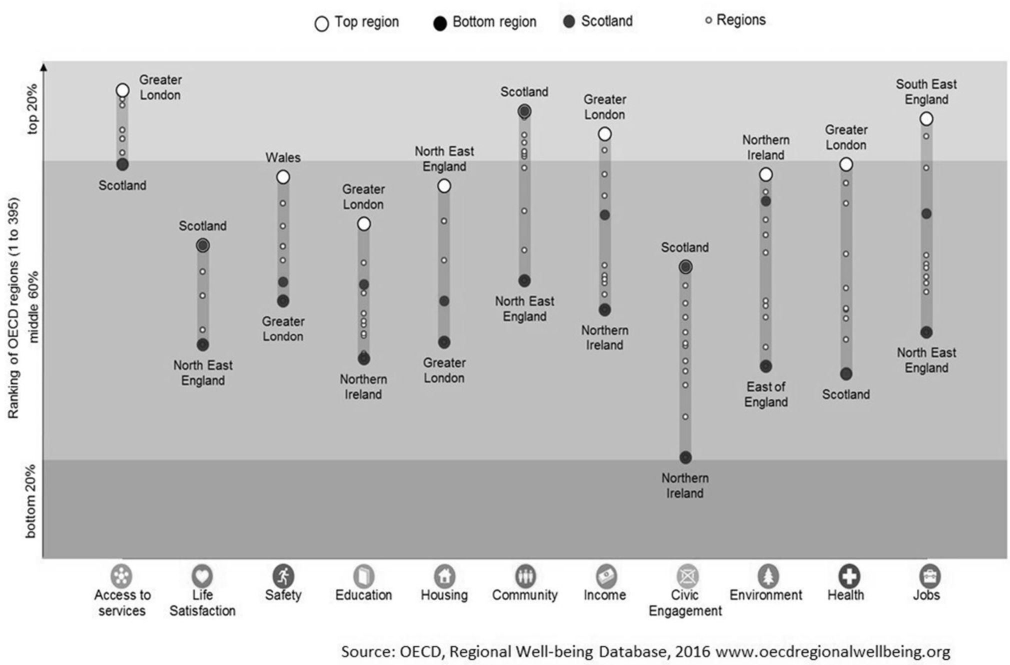
Figure 2: Regional and sub-regional productivity



In addition to this, Scotland's sub-regional productivity performance is more broadly diverse than all regions other than the North West, South East and London. While four Scottish sub-regions demonstrate productivity levels above the UK average (Aberdeen City & Aberdeenshire; the City of Edinburgh; Inverclyde, East Renfrewshire & Renfrewshire; and South Ayrshire), there are many that continue to lag substantially behind.

This view of sub-regional performance is reinforced by a similar comparison of wider factors that shows the variation between Scotland and the rest of the UK is even more marked. Figure 3 shows the different relative performance of UK regions against OECD regions by a range of measures of well-being.

Figure 3: "Well-being" performance of UK regions against rest of OECD



Scotland scores highest in the UK on Community, Life Satisfaction and Civic Engagement, and poorest on Access to services (as well as Health). But what is equally pertinent is that Scotland is the most extreme (top or bottom of the ranking) in the UK in these five categories, a total that is only surpassed by Greater London (six), which confirms the differences between Scotland and other (regional) parts of the UK.

Coupled with the divergence in the policy environment between Scotland and the rest of the UK – for example in housing, where there are now wide differences in legislation around homelessness and the nature of tenancies as well as a different approach to provision – this 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.

To give an idea of the macro-economic impact the bank could make, initial economic modelling undertaken by SG on behalf of the Implementation Plan suggests that whilst there will be benefits in the short-term from any additional investment made by the bank, the real prize will be how the bank is able to influence productivity and the overall liquidity of investment in the longer term. To give an idea of the macro-economic impact the bank could make, initial economic modelling undertaken by the Scottish Government on behalf of the Implementation Plan suggests that whilst there will be significant benefits in the short term from any additional investment made by the bank, the real prize will be how the bank is able to influence productivity and the overall liquidity of investment in the longer term. (For further detail see the accompanying Supporting Analysis paper.)

Consultation feedback

The responses received as part of the consultation process were overwhelmingly positive towards the proposition of a national investment bank. Respondents were keen to engage with the development of the Bank's scope and investment strategy. The responses suggested that there was a broad appetite across Scotland for a wider scope of support within the Scottish investment landscape and a requirement for additional capital. A number of respondents also cited that this was an opportunity to adopt a more ethical, socially just and environmentally aware investment strategy.

Summary

There is a strong and clear argument that the supply of capital to an economy through a NIB can fix market failures and address gaps in the financing markets for companies seeking finance to grow. A NIB can provide strategic leadership to support, create and shape new markets for investment and drive innovation targeted at particular economic, social and environmental objectives.

The strategic and economic cases for establishing a national investment bank in Scotland are compelling, supporting the economic ambitions of SG and the change and growth which will secure the nation's future. Review of the impact that international comparators have had on their respective economies provides confidence that such a Bank will enhance the performance of the Scottish economy.

Having an institution based in Scotland is important in order to connect its activities to an economy that is distinct from the rest of the UK in terms of geography, sector focus, infrastructure requirements and the supply and demand for capital to finance business growth.

Recommendations

Recommendation 1: A national investment bank should be established for Scotland with a vision to "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."

Recommendation 2: The Bank's strategic priorities for investment should be centred on a core role of helping to address Scotland's economic priorities in an inclusive and ethical way.

Focus for investment activities

2

The scope of the Bank

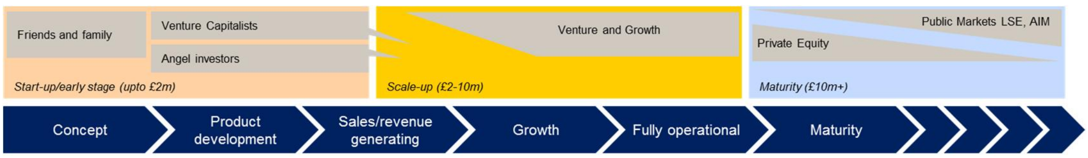
The Bank should be set-up to be an enduring institution that provides a step change in Scotland's economic architecture. It should unlock the potential for improved performance by providing the finance to help Scotland's businesses to realise new economic opportunities at home and abroad. It should do this by developing financial products to help realise growth opportunities across the economy, with a particular focus on areas that have a strong degree of innovation. Critically, it should focus activities on areas which can contribute most to the policy-driven missions identified by SG.

Financing this transformative change in an economy will require an institution that can both take a long-term approach which extends beyond the typical terms for private sector investment, and is prepared to act to make and shape markets in support of missions that define how the economy will develop.

Because innovation is highly uncertain and has long lead times, achieving smart, innovation-led growth requires not just any type of finance, but patient strategic finance. The Bank should, therefore, provide access to long-term patient finance, with a return in the 10-15 year horizon.

The Bank should have the capability to operate across all stages of the capital lifecycle requirement for companies (see Figure 4 in respect of equity investment stages) and by financing products such as senior debt, equity and mezzanine finance. In doing so, it should ensure that a range of financial products – where there are gaps or market-making opportunities – are available to Scottish businesses to support growth and bring clarity and simplicity to the end-user and consequently helping to reinforce demand for finance.

Figure 4: Equity capital lifecycle visual



Source: Scottish Government

The Bank should provide greater depth of access through provision of sufficient scale to enable transformative investments. This greater scale should also increase the demand for finance by acting as clear signal of ambition.

Gaps in the financing markets and mission-based finance

Market gaps

There is longstanding evidence of market gaps in access to finance and particularly in capital that enables firms to grow. Growth is uncertain, so returns dependent on achieving growth can be seen as more uncertain and higher risk. This is especially true where firms are small to begin with as it can be difficult to ascertain which growth plans have the potential to succeed. Not only this, but developing the expertise, analytics and relationships to enable good judgements to be made is expensive, meaning that finance providers such as banks and private equity firms often prefer larger transactions (and in the equity space, leveraged transactions).

These challenges mean that in a number of areas, viable firms with good growth plans can fail to find the finance they need. This has been attested in a number of studies, from the Macmillan study of 1931 onwards – including the Rowlands Review of Growth Capital[13]. More detail and analysis on market gaps is contained within the Supporting Analysis report that accompanies this Implementation Plan.

A further issue for growth capital is the time taken for returns to come where markets need to be developed. Time has the effect of lowering the annual rate of return if returns are not made quickly enough, and of increasing the risk of issues arising that reduce returns. This means that 'patient capital' can be scarce and this can affect the availability of capital for growth.

The Patient Capital Review[14], commissioned by the UK Government, illustrates there are clear barriers in accessing long-term, patient capital in the UK's under-developed and fragmented ecosystem. The review identifies several specific barriers to investment in patient capital including that the majority of financing is concentrated in London and, therefore, it is particularly difficult for businesses outside the capital to access the funding they require.

For gaps in the provision of lending to SMEs, it is important to look at specific circumstances and also how finance markets change over time. SG has developed analysis that suggests there are issues that affect the Scottish economy in the following areas:

- Debt gap – Estimated to range between £330m and £750m per year in Scotland[15]. Gaps exist from the very smallest levels of finance (microfinance from £500 to £25,000) and from £25,000 to £100,000 and extend up to £1m-£2m.

- Equity finance gap – The British Business Bank ("BBB") highlighted the structural market failures in its 2015 investigation into the provision of equity[16] and pointed to the information asymmetry between business and investor which necessitates costly due diligence in advance of any deal which is relatively fixed, meaning it accounts for a greater share of smaller deals, which drives investors towards larger deals and larger, less risk orientated firms. This gives rise to the classic "equity gap" first identified in the Macmillan study as long ago as 1931. As the market is becoming ever more complex and dynamic there are no longer fixed and easily identified gaps to address. Nevertheless, there is agreement[17] that there is also now a growing acute gap at the later stages, especially for innovative, growth companies seeking to scale up, at the £2m to £10m level. Within that grouping of companies, the gap particularly applies to pre-revenue and pre-profit companies and for those with delayed cash flows or in need of significant product development time, whereas capital is more likely to be available for those with a proven business model.

[13] Rowlands, C. (2009), The Provision of Growth Capital to UK Small and Medium Sized Enterprises (http://lincscot.info/wp-content/uploads/2016/12/rowlands-growth-capital-review.pdf)
[14] Buffini, D. (2017), Patient Capital Review: Industry Panel Response, UK Government: London, UK (www.gov.uk/government/publications/patient-capital-review)
[15] Scottish Government, 2015 The Market for SME Finance in Scotland, (http://www.gov.scot/Publications/2015/08/3776)
[16] British Business Bank (2015), Equity Research Report: Review of Equity Investment in Small Businesses, (http://british-business-bank.co.uk/wp-content/uploads/2015/03/050315-Equity-report-FINAL.pdf)
[17] Buffini, D. (2017), Patient Capital Review: Industry Panel Response, UK Government: London, UK (www.gov.uk/government/publications/patient-capital-review)

Developing a mission-based financing approach

A key benefit of mission oriented banks is that they are able to shape the direction of growth by making strategic investments across many different sectors and nurturing new industrial landscapes[18].

The Bank should, therefore, adopt a wide cross-sectoral perspective on growth opportunities. The missions set for the Bank would provide a focus for its investment strategy, but not constrain the Bank's activity. The Bank should support innovative, high growth Scottish firms in whatever sector they appear other than those activities that may cause reputational issues or go against the principles of the Bank's ethical investment code.

SG should be responsible for setting the missions for the Bank on a pre-determined timeframe and aligned to policy priorities. It is beyond the remit of this report to propose such missions, but examples based on existing Scottish economic policy might include:

- 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.

Complementary SG policies, regulation and alignment with the enterprise agencies will be necessary to achieve these missions and ensure there are viable firms and projects that can be brought forward for financing by the Bank. Further benefit can be realised where there are supply chain interdependencies and connections between and across relevant missions/sectors which have the potential to be mutually reinforcing. An example of what a mission-based finance approach could look like for the Bank is set out in Figure 5.

Figure 5: Case study – Transition to a low carbon economy: decarbonisation of the transport network

To illustrate the potentially transformative impact that mission-oriented finance could have on the Scottish economy, it is helpful to use an example. Consider the SG's mission to transition to a low carbon economy. To achieve this, a key priority will be decarbonising the transport network, including a move to electric vehicles, where the SG has set an aim to phase out the sale of new petrol and diesel vehicles by 2032.

To achieve this, significant investment is required to finance the rollout of nationwide infrastructure and to support technology advances to enable such change. There are currently significant challenges in the limited supply of vehicle charging points, underinvestment to date in the technology development required to ensure batteries are able to store energy for longer, as well as capacity issues with the current grid. Therefore, the investment required to support the economy transition would be in the form of nationwide vehicle charging infrastructure, technology development in enhanced battery storage, and increasing the capacity of the current grid system to enable longer energy storage and increased energy mobility. There is therefore an opportunity for Scotland to be an innovation leader in low carbon technologies, including in technology development, manufacturing and supply chain capabilities, which will use these technologies and can in turn be exported.

There are opportunities for the Bank to provide mission-oriented finance in the form of debt and/or equity in this context – from early, market shaping, cornerstone equity financing in infrastructure as part of an SG coordinated infrastructure rollout programme (crowding-in private investors), to providing patient growth and scale up capital to Scottish based companies developing technology solutions and building capabilities to realise the large scale manufacturing and supply chain opportunities presented by the mission. SG will also need to help create the right conditions for investment to get the best from this market in terms of policy and regulation. There is an evident opportunity for the Bank to play a pivotal role in achieving results in this rapidly developing market.

[18] Mazzucato, M. and Macfarlane, L, (2017), "Patient strategic finance: opportunities for investment-led growth in the UK". *UCL Institute for Innovation and Public Purpose, Working Paper Series* (IIPP 2017-05) www.ucl.ac.uk/bartlett/public-purpose/wp2017-05

Initial activities of the Bank

The broad role of the Bank should encompass growth capital and mission-based finance.

Growth capital

The evidence of market failure and gaps outlined earlier in this section, and in the supporting evidence base, means the Bank will be directed to supporting companies' growth ambitions, technology advancement, innovation and commercialisation, 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.

There is evidently an opportunity for the Bank to take an innovative approach when developing its financial products for the Scottish economy, for example, in trying to leverage additional finance from the value of intangible assets. The Bank should also have the resource and capabilities to be able to advise companies to help structure complex deals to increase the volume of successful finance raising activity in Scotland, recognising that there is a need to stimulate greater demand for patient growth capital.

Two case studies are provided in Figure 6 and Figure 7 to illustrate the types of growth capital products the Bank could make available to companies.

Figure 6: Case study – Renewable energy supply chain

A company developing new technology to improve the efficiency and lifespan of mechanical components in wind turbines has been funded to date by a combination of large R&D grants and early stage equity, including co-investment through the Scottish Investment Bank. The company has significant domestic sales opportunities, as well as potential for export activity. To move the business to the next stage of development (including developing a manufacturing base and funding a sales pipeline) a financing package of £10m is required.

The amount of support needed is beyond the scope of SIB's core funds and a lack of asset backing means securing meaningful traditional debt would be challenging. A package of equity and potentially mezzanine debt could be considered as a solution, involving suitable private sector investment partners as appropriate. The clear links to the low carbon agenda as well as innovation and scale up activity, this type of business, allied to the financing requirement and the contribution to likely missions, make this scenario a potential customer for the Bank, provided that the proposal adhered to prevailing risk parameters.

Figure 7: Case study – SME food and drink business

A family owned SME business with turnover of c£10m is looking to improve its manufacturing facilities to take on new contracts with large retailers and thereafter expansion into new overseas markets. Currently employing 35 people in a semi-rural location, with the expectation of adding a further 10 permanent jobs if the works on the manufacturing improvements go ahead. The planned improvements would involve the purchase of bespoke machinery and improvement to the fabric of the existing factory and would involve total expenditure of around £1.75m. The company can contribute £500k from cash reserves and its existing bank is prepared to provide a loan of £750k in addition to existing working capital facilities. However, due to the bank's view on asset cover there remains a gap of £500k in the financing package.

As one of the potential areas of activity for the Bank is the provision of debt finance for SMEs to address identified market gaps this financing requirement, this scenario is a potential customer for the Bank, provided that the proposal adhered to prevailing risk parameters. Any agreed financing would probably be provided by way of subordinated/mezzanine debt sitting alongside existing banking facilities.

Mission-based finance

This would encompass the financing of infrastructure, projects and initiatives that will help transform the economy. In doing so the Bank should support the government's broader policy objectives which, when combined with the appropriate regulatory and other levers, will create new markets for the Bank to finance. 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 innovations to meet new economic opportunities and societal challenges.

Clear activities for the Bank are to firstly provide viable companies with finance, where other investors will not invest, to commercialise the innovation and technologies, and secondly to provide finance for investment in new technologies and innovation that can contribute to the market making and acceleration of an economic opportunity. This is with a view to providing market confidence to accelerate the crowding in of private capital. This should create the environment to allow the Bank to consider full or partial exits from transactions once the market is fully established, other investors' confidence has grown or a new technological innovation has been proven.

Financial products

The initial product range that the Bank should focus on is:

Growth capital

- Provide SMEs with access to micro loan finance of up to £100K by the continuation of the existing activities enabled by SG'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 current unsatisfied demand

- Consider the potential to deliver targeted debt support through the creation of specific loan funds. An example of this being the recently launched Brexit Loan Fund to be established by the Strategic Banking Corporation of Ireland. This fund has an initial value of €300m and will be available to both SMEs and small Midcap companies who are already being or are expected to be impacted by Brexit, particularly in relation to export activity

- 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

- 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 initial area of focus recommended for the Bank is to develop products to support the transition to a low carbon economy, including infrastructure where financing can be scarce

- The Bank should also offer investment products that support mission-based investment (equity and debt) that enable and accelerate, at scale, place-making development activities, including housing development, regeneration and new business infrastructure and premises.

Appendix B sets out in broad terms the types of financial products the Bank could offer.

In bringing clarity to the scope of the Bank, it is also helpful to outline those activities that it should not engage in. These include the following, which are excluded due to an inappropriate fit with the Bank's remit and/or for operation reasons:

- The Bank will not take deposits, offer mortgages or other traditional banking products and services. As such the Bank does not need a network of branches
- The Bank should not undertake funding activities, such as the awarding of capital and revenue grants which are the remit of SG and its enterprise agencies. Instead, its focus should remain on financing activity, with any monies advanced must be repaid and be on commercial terms.

The existing public sector investment landscape

Scotland has well-established public sector support providing funding and financing advice and the provision of funding and financing directly or indirectly to companies seeking to grow, including Scottish Enterprise's Scottish Investment Bank, the Scottish Government's SME Holding Fund, the Scottish Growth Scheme and Scottish Futures Trust ("SFT"). SG has also developed several financing vehicles in response to market conditions and need particularly in respect of housing and regeneration activity such as the SPRUCE Fund and the Infrastructure Investment Fund. Appendix C sets out further details of the current public sector financing landscape considered as part of the development of the Implementation Plan.

The report recommends that the new Bank should integrate existing financing activities provided by SG and its agencies into its remit and operating model to build on the success of operations and initiatives underway, offering an opportunity to develop strengths and build on existing skills and align complimentary activity.

This integration should help achieve clarity of purpose and cohesion across the public sector financing landscape, simplifying the interaction with customers.

Scottish Futures Trust

SFT is an organisation owned by, but operating at arms' length from SG, with responsibility for structuring and delivering important infrastructure programmes and innovating to secure new ways of funding essential infrastructure. SFT works collaboratively with public and private sector bodies to achieve more operationally and financially effective public infrastructure, working on the investment planning, design, financing, delivery, efficient use and disposal of assets across Scotland.

The infrastructure delivery programmes led by SFT support the delivery of publicly funded infrastructure assets (including schools, hospitals and roads) paid for out of general taxation. SFT does not act as a source of finance or investment in the delivery of infrastructure, except via its wholly owned subsidiary Scottish Futures Trust Investments Limited ("SFTi"). This subsidiary invests relatively small sums[19] on behalf of SG in specific infrastructure companies, assets and projects across Scotland to support the particular commercial structures where infrastructure is being delivered by programmes that SFT is responsible for, such as, subordinated debt into Design, Build, Finance and Maintain ("DBFM") projects in the hub programme.

[19] As at 31 March 2017, SFTi had invested £13.6m into 31 separate hub projects.

The Bank will be a key stakeholder for SFT to work collaboratively alongside, to ensure that the objectives of SG in delivering value for money infrastructure investment are achieved in a joined-up manner by both organisations, albeit operating with separate and distinct remits. Where SFT currently provides advisory support to the public sector in respect of the financing of specific government initiatives, such as low carbon infrastructure (e.g., via the Scottish Energy Efficiency Programme), it is anticipated that SFT would also work with and alongside the Bank to assess the financing need/opportunity for the Bank in supporting such programmes.

British Business Bank

The BBB is a UK Government owned business development bank dedicated to making finance markets work better for small and medium businesses. It has a UK wide mandate. The BBB offers support to delivery partners at a range of levels, by providing the capital required to start a business, grow it to the next level or stay ahead of the competition by providing a greater volume and choice of finance.

The Bank should seek to encourage and facilitate BBB investment in support of SG aims, and its own activities should complement and be aligned with the activities of the BBB to ensure Scottish businesses benefit from the most effective mix of support mechanisms possible. Where there is the potential for overlap the Bank should take the lead in establishing the strategy for alignment.

UK Export Finance

Export finance is a crucial component of the financing landscape, particularly for innovative companies who need to get their products to as wide a market as possible in a short period of time to profit from their innovation and market leadership. Growing firms and firms that are rich in intellectual property, but poor in traditional, physical assets, can find it difficult to support the bond requirements that often come with exporting, and can also find working capital requirements stretched as their balance sheets are used for necessary bond and insurance products.

UK Export Finance (“UKEF”) has over the past few years greatly expanded its support for smaller firms in the UK, including in Scotland, and has launched a number of new products aimed at supporting exports. However, it is vital that Scottish exporters have at least as strong support as firms in the rest of the UK, and while export finance will not form part of its initial set of products, the Bank should maintain a watching brief on the export finance market in Scotland and develop interventions if they prove to be necessary.

Investment strategy

The investment and financing market in Scotland currently provides financing across a range of investment products, from early stage and venture capital, to scale-up growth capital and senior, mezzanine and subordinated debt. The Bank should provide economic benefit by augmenting this existing market and where appropriate taking a lead on new financing requirements to catalyse activity from existing market players.

In order to do this, the Bank should focus on financing firms whose needs for capital are inadequately serviced by the market, either because the market feels it is unable to manage the level of risk as part of investors’ remit in more conventional portfolios or because the timescales required for the return to be realised are longer than conventional investors can accept. For example, banks which are constrained by regulatory capital rules and funds with requirements to pay investors in a certain timescale can be averse to illiquid assets that require an unknown exit event for the return to be realised.

By investing or lending differently, and by adopting a potentially alternative appetite for risk and the liquidity of investments, a new and valuable approach to financing can be introduced to the Scottish financing market although in doing so the Bank will adopt a commercial basis for its investments.

The Bank should become an enduring institution whose impact continues to grow over time. In order to achieve this, the key principles that should guide the Bank's Investment Strategy should cover:

Key principles
• The Bank should seek to ultimately develop into a self-sustaining institution. It is estimated that this could take 10 to 15 years from inception.
• The Bank should increase the impact of its interventions by crowding-in private finance, developing new markets and growing the economy. Leveraging in private capital alongside its own investments can happen through co-investment or through an asset management structure where the Bank and the private sector agree on a specific investment mandate.
• The Bank should act wholly commercially in taking decisions based on the viability of the firms or projects in which it invests (either by itself or with others) and the expectation that it will generate positive returns from all of its investments. In some cases it will invest on full commercial terms and taking the same returns as the private sector. In other areas (e.g., where State Aid rules allow, in response to specific market failures) it may be appropriate to take different risks or different returns to the private sector, but always in expectation of a commercial return.
• The Bank should also 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.
• The Bank should look to maximise impact by catalysing activity that otherwise would not happen. This would most effectively be achieved by placing the Bank at the centre of the investment process, nurturing knowledge and expertise, coordinating other stakeholders in the investment ecosystem and acting as investor of first resort – not just investor of last resort.
• The Bank should invest at different levels of risk in different areas, and potentially take risks the private sector does not currently have the appetite for without public intervention, or does not have the appetite for in sufficient scale to meet the need. As time progresses, private capital should enter markets once evidence around risks of particular investments is better known and evidenced, such as commercialisation risk for a new technology.
• The Bank should spread its actions across different types of investment activity to achieve a balanced portfolio and generate sufficient returns to enable it to be self-sustaining. This means that the Bank's activity will be in a range of areas at different levels of risk and over a different set of timeframes.
• The Bank should 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 Bank should be open to investing differently to existing available private finance markets should be central to the remit of the Bank, with freedom from regulatory capital constraints being a key differentiator for the Bank in how it assesses opportunities.
• The Bank should invest ethically, developing and implementing its own ethical code for investment.

It is for the Bank's Executive Management Team to develop a detailed investment strategy and the specific financial products required to deliver the Bank's investment objectives. We anticipate that those objectives will change over time to meet evolving market circumstances, and the Bank should have capacity to follow gaps in the market as they emerge/dissipate.

Crowding in private capital

The Executive Management Team should ensure private capital is crowded-in wherever possible. Public sector ‘first loss’ positions are not attractive as not only can they result in poor investment returns, but also misalign incentives that can result in a lower quality investment strategy overall.

There are examples of successful interventions which have brought in private funding, including the co-investment activity taking place through the SIB which has leveraged significant private capital and the UK Government’s Enterprise Capital Funds. The success in early stage equity markets provides confidence that Scotland can repeat this in other areas led by the Bank.

The work that the Bank can do in helping to innovate and structure deals, especially where the Bank acts as a cornerstone investor in transformative projects, will be instrumental in enabling a wider range of private capital to invest in projects and programmes they would not normally be able to access. It can be that institutional investors such as pension funds who may wish to invest in an asset class (such as infrastructure) can lack the capability to access those opportunities. The Bank should seek to catalyse this investment and help to bring in those potential providers of finance.

Intangible assets

To reflect the trends within a modern, dynamic and knowledge-driven economy, the Bank should also look at ways to improve the market for finance through leveraging Intellectual Property and intangible asset valuations. By intangible assets, we refer to intellectual property, patents and skills which cannot be easily valued, and are often illiquid.

Many innovative companies are intangible-rich, but tangible asset poor, meaning that traditional lending and investment methodologies fail to recognise the value of the company and finance is hard to access. In this context the Bank could investigate creating a system around valuation of intangibles to provide collateral to lend against. While many private institutions are interested in the valuation of intangibles, the ability of a NIB to co-ordinate and stimulate the use of a potential system or standard could be invaluable to companies seeking finance.

Consultation feedback

Respondents to the consultation process noted that in order to support economic growth, an addition to the financing landscape, which took a different approach, was necessary. Many finance providers were thought to be too short-term and unable to properly support growth. There was criticism of the current market situation and respondents felt that the Bank should provide additional support for Scotland’s small and medium sized enterprises and be able to be a source of patient capital enabling firms to grow.

Many respondents wanted to ensure that the Bank’s efforts were focused on providing services for which there was a gap in the market and where failures meant that finance was not available, rather than replicating currently available offerings. There was a strong response to indicate that there are market failures in the provision of finance, particularly in early and growth stages. Opinions varied as to the exact shape of the financing gap – some respondents focused on sub-£1m funding, others that larger sums up to £10m should be the focus.

In addition, many respondents also felt that simply providing finance was not enough. In order to secure the sort of transformational change that is aspired to, a large number of respondents wished to see further support, in order to help bring forward projects and businesses who might otherwise be locked out of further financing as a result of a lack of commercial awareness or business planning expertise.

Summary

The Bank should support the following areas of activity:

- Growth capital – providing strategic and patient capital at early and growth stages of firms' development so that they are able to accelerate innovation and make a stronger contribution to the Scottish economy

- Financing infrastructure, projects and initiatives that will transform the economy, supporting the missions developed by SG.

These investments should come through a variety of instruments, including debt, equity and mezzanine finance, to suit the risk profile of the underlying investment. Over time, the Bank should be able to reinvest capital and the management team should be able to develop a portfolio that balances the risk of the various investments and the timeframes of expected returns.

The Bank should build on the success of existing public sector financing operations utilising the skills and knowledge available, given the clear alignment with the Bank's agenda. The most significant is Scottish Enterprise's SIB and SG's SME Holding Fund and the Scottish Growth Scheme. This will also ensure that the new Bank will simplify, not complicate, the existing financing landscape creating a coherent setting for those firms looking for finance.

The Bank should operate under a clear set of commercial principles aiming to make a positive return on individual investments and over the long-term at a portfolio level and become a self-sustaining institution. It should also commit to maximise additionality to the current market and improve the financing landscape for Scottish firms.

Recommendations

Recommendation 3: This new, mission-led institution will actively create and shape markets. It will intervene in a variety of areas – to supporting early stage and smaller firms and larger scale innovative projects get access to investment, through to financing infrastructure where the private sector will not invest. The initial focus of the Bank should be:

- *Providing growth capital to ambitious and innovative companies – with the capability to support across the lifecycle of a company's need for capital*
- *Providing finance to support the projects and initiatives aimed at realising opportunities to transform the economy.*

The Implementation Plan sets out a range of financial products that the Bank should seek to develop to support this initial focus.

Recommendation 4: In addition to the supply of capital, 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 who provide a range of support services to companies, and with the Scottish Futures Trust in relation to its activities on infrastructure.

Recommendation 5: The Bank should aim to 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, complementing rather than crowding-out existing or potential investment.

Recommendation 6: The Bank should adopt a balanced portfolio approach across a range of potential products and asset types. Its target should be to achieve a positive financial return on its individual investments, and at a portfolio level which should be measured over at least a 10-15 year horizon, recognising the focus on investment in patient capital and transformative infrastructure.

Recommendation 7: Scottish Ministers should determine an appropriate basis for measuring the Bank's performance, taking into account the long-term nature of the investments and mission-orientated approach that's envisaged for the Bank. A balanced scorecard approach is required that reports on the financial performance as well as on economic impact over time, including social, environmental and ethical returns.

Recommendation 8: The Bank should seek to maximise leverage of private capital as appropriate, alongside its own investments. In doing so, it should adopt a flexible approach; it may be appropriate for the Bank to invest or lend directly alongside private sector investors through third party delivery agents or via external funds.

Recommendation 9: The Bank should build on current skills and experience successfully developed in Scotland, building on the track record of success, and creating a single point of delivery of financing support for business growth and innovation financing for transformational projects.

A detailed review will be required in response to this recommendation in order to achieve the optimal operating model and ensure essential close interaction between the Bank and the enterprise agencies, including how to ensure co-ordination of funding, company relationships and financial readiness activities that will be provided by the agencies.

Recommendation 10: The Bank's activities should be aligned with the activities of the British Business Bank in Scotland, which may require establishing a strategy for alignment between both institutions.

Classification and capitalisation of the Bank

3

The issues of classification and capitalisation are linked. 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.

Structure of the Bank

In developing the recommendation for the structure of the Bank, the following issues were explored:

- Ownership – establishing the Bank as a public or private sector institution
- Regulation – specifically the need to apply for a banking licence
- Form – the appropriate corporate structure for the Bank.

There are a wide variety of potential structures for the Bank. While there are some examples of private sector institutions that work in partnership with governments to meet policy objectives, such as the Business Growth Fund in the UK, the expectations of return and types of risk that the private sector is prepared to take are a barrier to a private sector body being able to carry out the range of investments envisioned for the Bank. Given this the Bank should be part of the public sector, though part of its remit should be to leverage in private capital at the level of investments or funds.

Many of the investments that the Bank will make will be through equity, or equity-like instruments. This means that it will not be a bank in the traditional sense of a financial institution that loans money and manages the credit risk on those loans. As well as credit risk, banks manage the maturity risk between the money they lend and their funding; for this reason they are regulated in terms of the equity (regulatory capital) and the liquidity risk they bear. This structure would therefore not suit the remit of the Bank as it seeks to be as flexible as possible in the nature of its financing support, and nor would it aim to take deposits. The Bank would act across different types of investment and therefore an asset management structure would be appropriate. As such, it was concluded that the Bank would not require a banking licence.

In order to establish a corporate body to manage assets, SG could set-up a statutory non-departmental public body. However, this process and structure could be complex, would not be an ideal fit for a financial institution, and would not add anything to what could be achieved through a company structure. Therefore, the proposition is that the Bank should be formed as a limited company owned by Scottish Ministers. For the Bank to operate in the way envisaged and set out in this report, it must have a separate legal personality and the ability to establish subsidiaries with specific purposes for investment and fund management in order to meet regulatory obligations.

Classification

To ensure the sustained alignment of the Bank to national economic policy, Scottish Ministers will need to set the strategic direction of the Bank. This means that, as discussed above, the Bank will be classified as a public body. In order for the Bank to have the desired impact it will also require:

- Administrative and operational independence. This will provide assurance to external stakeholders and other investors that it will operate on a commercial basis in those areas that align with SG's strategic direction
- The flexibility to mix products to be offered and operate in different market areas, adapting to changing market conditions as necessary
- The ability to attract staff through appropriate terms and conditions with the right mix of skills and experience for successful delivery of the Bank's mandate (including personnel with banking and investment backgrounds).

As a supplier of patient capital with an investment horizon of 10-15 years, the Bank will require public capital and budget support from SG for upwards of 10 years, both to run the Bank and meet its operating costs, as well as capital for making investments. This means the timeline for any recycling of capital would be longer than most other private investments.

Capitalisation

In time, the aim for the Bank should be to make a positive financial return and become self-sustaining. However, it will require capitalisation from SG to commence activities. An early commitment to this has been made by SG in the 2018-19 Draft Budget with an undertaking to provide initial capital of £340m over 2019-20 and 2020-21.

The Draft Budget also announced establishing a new £150m Building Scotland Fund (£80m in 2018-19 and £70m 2019-20) to increase housebuilding, commercial property and R&D. It is proposed that any investments entered into by this Fund and any pipeline investments and remaining balance on the Fund transfers to the Bank for its shadow year of operation in 2019-20.

The proposed target level of initial public capital for the Bank from SG is a minimum of £1bn over the first 5 years. A further £1bn target should be set for public capital in years 6-10. This scale of public capital is deemed to be of a level that will make a material difference to the supply of capital to the Scottish economy, balancing the need to capital with the availability of resources that SG can allocate.

It is also consistent with other NIBs. 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.

Non-Government sources of finance

A key objective of the Bank will be to bring in other sources of capital to supplement the activities of the Bank. Most successful NIBs area 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 for NIBs around the world.

Over the longer term the Bank should also look to leverage its initial capital base, further strengthening its investment capability. However, 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.

From the outset, however, the Bank should bring in private capital to advance its objectives at the level of particular interventions where the investment criteria and expected returns are clear. This has been achieved successfully elsewhere, including in Scotland via SIB, which has leveraged significant private capital.

Milestone objectives

The Bank should seek to reinvest its financial returns, both capital and interest, to create a lasting, self-sustaining institution with increasing influence on the Scottish economy. To achieve this, there are some key milestone objectives:

- To secure a dispensation from HM Treasury to have the flexibility to manage, retain and carry-forward cash balances over financial year-ends
- To become self-funding over the medium-term that is; the Bank covers its operating costs from investment returns
- To be able to raise capital in its own right and no longer be reliant on capital advances from SG to fund its investments.

Initial HM Treasury dispensation

Each year, 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.

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 its recent privatisation) and to BBB, which has an on-going dispensation over and above BEIS' existing budget to invest public capital into SMEs. A similar arrangement is in place for Scottish housing associations, on a temporary basis, which are currently classified to the public sector whilst legislation is passed to reduce public sector control over these bodies and return them to a private classification. Without such dispensation the Bank would be unable to deliver the scale and ambition which is set out for it here, including through the adoption of a long-term, patient investment strategy.

Resource costs

At this early stage, it is not possible to give a fully accurate assessment of the running costs of the Bank. Much of this will depend on the precise nature and timing of the investment activity of the Bank, and its operating model, and how it is able to work with third parties. However, an exercise was undertaken to look at comparable organisations and also built up potential costs based on the activities set out in this plan. Costs would include staff, corporate administration resources and systems for financial management and investment and risk management.

The potential running costs for the Bank when fully established are estimated to be between £20m and £30m per annum. This would allow for an organisation that would have circa. 100 to 150 people working for it and engaging in a full range of investment activities. This will allow the Bank to have the scale of effect on the Scottish economy that is desired.

The Bank should be set up as efficiently as possible, with many resources re-deployed into the Bank where possible. In the first three years of the Bank's operation, the costs would be lower as the Bank expanded its activities and brings current finance activity on board.

Summary

The initial capitalisation of the Bank will be from SG, and given the timescales that are required to invest 'patient' capital (whether debt or equity), support from the government will be required for a number of years.

The Bank will be classified to the public sector (central government) when it is set up, although it will have operational independence from government. This means that in order for the Bank to retain funds over the long term and reinvest in the Scottish economy, some dispensation from HM Treasury will be required to enable flexibility in the carry forward of cash balances over financial year-ends.

A key objective will be for the Bank to leverage its initial capital base and raise its own bonds. It is recognised that dispensation from HM Treasury will be required for the bank to raise its own finance.

Recommendations

Recommendation 11: The Bank should be established as a public body to ensure a continued focus on the Scottish economic strategy and alignment with a mission-based approach to investment. The form of public body should ensure maximum flexibility in how the Bank invests.

Recommendation 12: Long term, mission-orientated investment requires a long-term capitalisation and funding commitment by the Scottish Government. The target level of initial capitalisation is £1bn for new activity, provided over the first five years followed by a further £1bn over years 6-10.

Recommendation 13: Three essential milestones should be set for implementation and successful operation of the Bank at the scale envisaged:

- *To be set-up with the flexibility to manage, retain and carry-forward cash balances over financial year-ends*
- *To become self-funding over the medium term that is; the Bank covers its operating costs from investment returns*
- *To be able to raise capital in its own right and no longer be reliant on capital advances from the Scottish Government to fund its investments*

Governance arrangements

4

Establishing a framework for good governance

Operating on a commercial basis, to the highest investment management standards and operationally independent of SG, the Bank will be in a position to make robust investment decisions without undue influence or control from SG. It is important that the day to day management and operational activities be at arms' length from SG.

The Bank should maintain its mission-led focus over the long-term, having the confidence to operate in areas which the wider market tends not to consider and accepting a different risk profile to other investors. This should be achieved by the Bank following the governing principles and arrangements described below:

- Scottish Ministers should be able to set, monitor and, where appropriate, amend the overall missions for the Bank and the rules or parameters within which the Bank invests, and to fully understand the risk consequences and contingent liabilities which arise from the various missions undertaken by the Bank. SG should do this by establishing a five year Strategic Framework for the Bank to work within

- The Bank should develop its Investment Strategy and Business Plan in response to the Strategic Framework – establishing its priorities within the framework and retaining discretion about what it invests in, when investments should be made and the nature and value of investments. The Investment Strategy should align with the five year period of the Strategic Framework, whilst the Business Plan will be developed and updated annually

- The Bank's Board will be fully responsible and accountable for the approach taken to delivering its missions

- The Bank should be operationally and administratively independent of SG

- There should be clear reporting and accountability of performance and outcomes, which is supported by an appropriate remuneration framework which promotes and ensures robust risk conforming and independent behaviour by the management of the Bank

- Given its expected mandate from Scottish Ministers, the potential for the Bank to invest with and on behalf of third parties, and the high level of external scrutiny which the Bank is likely to face, it must operate to very high standards of risk management, regulatory compliance and transparency.

The overall nature of the relationship to SG and the governance arrangements should be made clear through the Bill needed to establish the Bank, which will include how the direction will be set by Ministers. The Bill and its accompanying documents should detail the respective roles of Scottish Ministers, the Board and the Executive Management team, and the formal reporting and accountability arrangements

The appointment of the Chair and Non-Executive Directors will be made by the Scottish Ministers, and the board will likely contain a minimum of two Executive Directors (Chief Executive Officer and Finance Director).

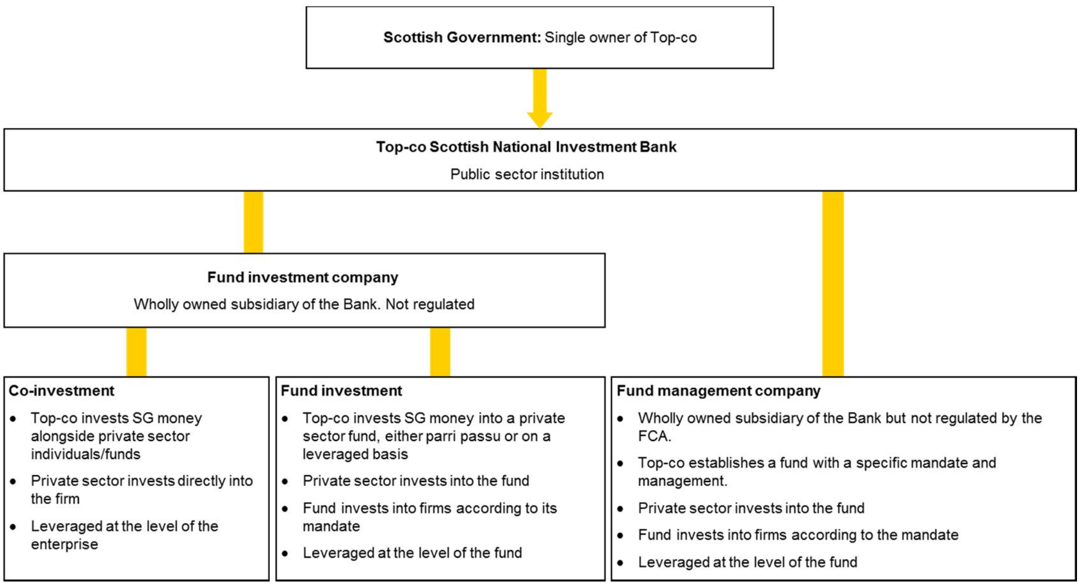
Corporate structure

The legal structure proposed in Figure 8 reflects the target model suggested for the Bank, and the broad parameters proposed for its relationship with SG.

To ensure that the Bank remains aligned to SG's economic strategy, it is envisaged that the Bank should be a limited company with Scottish Ministers being the sole shareholder, for the reasons outlined previously. Some of the capabilities envisaged for the Bank include the setting up of subsidiaries for co-investment activity, which should help ensure State Aid compliance and secure appropriate State Aid and Regulatory approvals to carry out the different functions, such as managing investments or making market investments.

As set out in Figure 8, there should be a 'Top-co' structure with subsidiaries underneath the parent institution to carry out specific functions and different types of investment activity. This enables appropriate regulatory and State Aid frameworks to be aligned to the functions which each of the subsidiaries are anticipated they will perform. The precise structure, however, will be subject to the Board's and Ministers' views.

Figure 8: Example of ' Top-co ' model with different subsidiaries



The Executive Management Team should manage the day-to-day running of the Bank, with the necessary responsibility and autonomy for implementing the Strategic Framework agreed by the Board with Ministers. This should include determining the relationship between the 'Top-co' and other parts of the Bank, such as:

- Risk and Compliance: ensuring operation within the Bank's regulatory framework and managing risk under the scrutiny of the Audit and Risk Committee and, potentially, Audit Scotland

- Financial Management and Treasury: managing the Bank's balance sheet and ensuring its on-going liquidity, including the management and direction of its budget allocation

- Investment: responsible for implementing the Bank's investment strategy, for investment recommendations, for decision-making on lending and investing to the extent delegated by the Investment Committee; and for investment execution

- Asset Management: responsible for managing the Bank's range of investments and loans.

The Bank's risk culture should inform effective risk management. This should reflect the Bank's nature of a 'promotional bank' business model for which generating profit is not the primary focus. It should also seek to establish a trading book which is inherently stable (insofar as the strategic investments linked to delivery of missions set for it, and its market making role will allow).

The expected high public profile of the Bank, its role and position within wider Scottish society, its anticipated impact on the economy and its mission-orientated mandate all increase the need for substantial transparency, regularity and probity in the way that the Bank operates. It should expect to make much information routinely public, in recognition of the wider public interest in its activities whilst also protecting commercial confidentiality. This should include, for example, information being made public about investment decisions, investment performance, organisational costs, staffing structures and remuneration levels.

Diversity and inclusiveness

Companies across all sectors with the most women on their Boards of Directors significantly and consistently outperform those with no female representation – by 41% in terms of return on equity and by 56% in terms of operating results[20]. The Bank should play a clear role in promoting diversity and inclusiveness. Included within this there should be an expectation that the Board and Executive Management Team are gender-balanced.

Different groups also face different constraints with regards to access to finance. For example, the ability to access finance has been highlighted by a quarter of women business owners as a key challenge to them starting their own business, and evidence has shown that women on average start their businesses with a third less capital than that of their male counterparts[21]. The Bank should consider how it could play a role in addressing this challenge.

To help inform the content of SG's Strategic Framework, including the nature of the identified missions for the Bank, SG should assess the optimal means of consulting with representatives from stakeholders and wider civic society. This report recommends establishing an advisory group, with membership drawn from a cross section of external stakeholders, to advise SG on setting the Strategic Framework and reviewing the performance of the Bank against this framework. It is also proposed that the chair of this advisory group would have a place on the Bank's Board as a non-executive director member.

Summary

The Bank should be a limited company, wholly owned by SG. The Bank should be accountable to the Scottish Ministers for its performance, and through them to the Scottish Parliament. SG should have the ability to set and monitor the overall mission of the Bank.

The Bank should operate at arm's length from SG, and it should be independent in determining how to develop and market its products and in making investment decisions.

The governance structure of the Bank should have a clear distinction between the roles of the Board (Executive Directors, Non-Executive Directors and Chair) and the Executive Management Team. The Bank will have subsidiaries that would be responsible for various parts of its activities under the overall umbrella of the Bank. This will facilitate regulatory and State Aid clearance for those activities.

[20] McKinsey (2010), Women Matter (https://www.asx.com.au/documents/media/2010_mckinsey_co_women_matter.pdf)

[21] The Federation of Small Businesses (2016), Woman in Enterprise: The Untapped Potential, (https://www.fsb.org.uk/docs/default-source/fsb-org-uk/fsb-women-in-enterprise-the-untapped-potentialfebc2bbb4fa86562a286ff0000dc48fe.pdf?sfvrsn=0&sfvrsn=0)

The Bank should adopt a leadership role with regards to diversity and inclusiveness. For example, it should have gender balance across its Non-Executive Director Board members and it should seek to engage with a broad range of external stakeholders.

Recommendations

Recommendation 14: As sole shareholder and sponsor of the Bank, Scottish Ministers will need to set the parameters within which the Bank should work. To do this Ministers should set a five year Strategic Framework for the Bank to respond to in its Investment Strategy and Business Plan. The reporting framework should ensure the highest standards of transparency and accountability.

Recommendation 15: The Bank should be administratively and operationally independent of Scottish Ministers. The Board should include a Chair and non-Executive members appointed by Scottish Ministers, and two Executive Directors in the shape of the Chief Executive Officer and Finance Director. There should be an appropriately experienced and professional Executive Management Team.

Recommendation 16: The Scottish Government should consider how best to consult with wider stakeholders on setting the Strategic Framework for the Bank to ensure that there is broad engagement with civic society on how the Bank is operating. This report recommends that an advisory group should be established whose membership comprises representatives from stakeholders and wider civic society. The group should advise Ministers on the Bank's Strategic Framework. The Chair of this advisory group could be on the main Bank Board as a Non-Executive Director.

Recommendation 17: The Bank should establish and operate to the highest standards of transparency, accountability and management of risk. This should be reflected in the reporting and accountability arrangements to be put in place, and in the formal governance arrangements of the Bank.

Transition plan

5

The process to establish the Bank

The transition to a fully operational and independent Bank should start immediately. It should constitute an on-going process as the organisation is able to increasingly act as an independent and fully formed institution. Appendix D sets out the high level tasks required to establish the Bank and expand the range of its activity over time, with an initial target of a shadow year of operations in 2019-20.

Many of the required steps, such as engagement with State Aid and regulatory authorities, will involve an extended process that the Board and Executive Management Team will need to navigate to enable the Bank to commence activity and expand the range of its activity and should therefore be initiated as soon as possible to avoid delays as the organisation develops.

An important process is transitioning, integrating and building on the current public sector financing elements.

SG should use its existing powers and operations to begin to undertake some of the investment activity that will be part of the Bank in order to show progress and begin to build the portfolio of investments for the Bank. An important element will be to ensure coherence for firms looking for finance in Scotland, helping them see a difference in the strength of the offer.

Many of the activities set out below will be taken forward concurrently, so that by 2020-21 the Bank is able to start its activity as a fully independent and effective organisation. The key workstreams are:

- Legislation and corporate structure – drafting and passing considerations, including setting up of relevant companies

- Budgetary – capitalisation, including any dispensation from HM Treasury, and resource budget for the Bank

- Senior appointments – appointments of the shadow Chair, and Board and Executive Management of the Bank

- Business planning and internal governance

- State Aid and regulatory clearance.

Some of the key points in the set-up of the Bank and interdependencies are set out below.

The legislative process and formal set-up

Primary legislation is required to enable SG to formally establish the Bank. It is anticipated that this process could take 18 to 24 months, and should therefore be commenced during early 2018 to allow for sufficient time for the Bank to undertake activity in its own right by 2020-21.

While some shadow bank activity can take place prior to the completion of the legislative process, the Bank will only have a properly independent existence (including entering into contracts in its own right including the direct employment of staff or appointment of a formal Board) once the legislative process is completed.

Scottish Ministers will set the direction for the Bank and highlight missions that it should undertake. Initial drafting of an interim Strategic Framework should commence early to enable the interim Executive Management to develop an initial Business Plan that responds to the direction set by SG during the establishment and transition stage of development so that the Bank can operate in shadow form during 2019-20.

In order to achieve the operational independence envisaged and to be able to access private capital in due course, the Bank should be an independent legal entity. It is proposed that the Bank will adopt a Top-co structure with subsidiaries carrying out certain distinct functions. This enables these subsidiary entities to have the appropriate regulatory and State Aid frameworks for the functions they are performing, as well as ensuring State Aid compliance.

Management of the transition

The first stage in the transition should be the forming of a Project Team, including a project budget from SG, and a shadow Chair to deliver the transition. The project team and shadow Chair should be in place by Q2 2018.

An interim Executive Management Team would be established to oversee the activities to establish the Bank, transition of existing operations, development of appropriate corporate governance and operational structures, and commencement of new activities under the Bank's remit in due course. These appointment should be made by Q4 2018, in advance of the shadow year of operations in 2019-20.

Formal appointments

Once the Bank is fully established with its own independent legal existence, a permanent Chair, full Board and permanent Executive Management Team would need to be appointed through an appropriate process. The Board should establish appropriate Committees to govern the Bank's activities. Executive Management will be responsible for putting in place effective risk assessment and investment processes and procedures. The Bank will likely be subject to the normal requirements of all public bodies (for example the Scottish Public Finance Manual) and will need to take account of such requirements in its internal policies and procedures.

An Executive Management team, will be led by the Chief Executive and will manage the day-to-day running of the Bank independent of SG. The Management Team should be established to ensure that it can cover the following four main functions within the Bank:

- Risk and compliance
- Financial management and treasury
- Investment
- Asset management.

Business Plan

Preparation of an initial Strategic Framework and missions should commence early, to enable the interim Management Team to develop an initial Investment Strategy and Business Plan that responds to the strategic direction set by SG in the Strategic Framework.

The key task of the interim Management Team would be to develop a business plan that sets out how the different functions described above would be developed in the Bank, what investment activity it would undertake in its first years of operation, and how it would develop a balanced portfolio of investments that represents an addition to the Scottish financing landscape. This plan should also include the institutional development of the Bank and fit with the legislative process in setting out how the relationship with SG will work. It should be a living document that will develop as the Bank comes into being, gaining in complexity and depth as time goes on and more clarity is available to the Bank as to the appropriate nature of systems, etc.

While it will not necessarily be used as part of a formal regulatory clearance process in the first instance, best practice indicates what the Business Plan should cover – the key components of the Business Plan are set out within Appendix E.

Obtaining Financial Conduct Authority compliance

The Bank will need to demonstrate to the relevant authorities that it maintains high standards of governance in its management, as well as having the operational capabilities and infrastructure to deliver the proposed suite of products. If the Bank is established as an Asset Management firm it will be regulated by the Financial Conduct Authority ("FCA") prior to conducting any regulated activities. The FCA's primary objective is to protect consumers, enhance market integrity and promote competition.

While it is unlikely that in the first instance the Bank would need FCA approval (though this may be necessary soon after the Bank's set-up). The set of issues that the Bank needs to address should be the basis of the Business Plan that the management of the Bank will be tasked with developing, to ensure once activity commences, the Bank is capable of properly undertaking its activities and making investments.

As part of the compliance process, the Bank will have to demonstrate adequacy of capital and liquid resources, and develop contingency plans for recovery, resolution and business continuity.

State Aid clearances

It is anticipated that the Bank will be classified as a National Promotional Bank ("NPB") by the European Commission ("the Commission") 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, but does not change the latitude given for different interventions, which remains the same for current member states. The Bank, is expected to be able to act through the General Block Exemption Regulation ("GBER") for risk capital, the Market Economy Operator Test ("MEOP"), and any schemes specifically notified to the Commission.

It is recognised that Brexit has created uncertainty in this area. The process to look at State Aid should be started by the Project Team as an early action, so that it does not become a block to speedy progress. The summary timeline, included in Appendix D, plans for up to 18 months for this process to be completed.

Recruitment of staff

The Bank needs to be highly professional and operate with very high standards of compliance and conduct. The Bank must be able to attract the right expertise into its management and delivery teams, given it will be competing for specialist staff with the private sector.

As well as financial and investment expertise, the Bank should aim to recruit or have access to a range of staff from other disciplines and specialisms, such as economists, statisticians, construction, engineering and scientific sectors. This is both to support its management and governance functions and to ensure there is sufficient knowledge of the sectors in which the Bank is likely to be actively investing[22].

The culture of the organisation needs to be expert and professional in terms of operating in the financial markets, attracting appropriate, high quality individuals and ensuring very high standards of compliance and conduct. There will need to be a cultural balance struck between the organisation having a focus on delivering against stated public policy objectives, retaining focus on the mission, and attracting investment professionals with the appropriate skill and expertise.

Summary

The Transition Plan will be comprised of a series of workstreams required to complete the set-up of the Bank. These include: legislation, recruitment of an interim Executive Management Team, regulatory and State Aid compliance, further recruitment and alignment of relevant organisations. A key part of this will be the development of a detailed Business Plan by the management of the Bank.

Recommendations

Recommendation 18: In setting up the Bank, Ministers should appoint an independent shadow Chair as soon as possible, to oversee the work of a project team responsible for the transition and set-up of the Bank. A shadow Board and interim Management Team should be put in place prior to the Bank operating in shadow form in 2019.

Recommendation 19: Scottish Ministers should concurrently confirm the Bank's initial missions and the first Strategic Framework, ensuring that the essential clearances and changes required are obtained from HM Treasury and others.

Recommendation 20: The Bank will need staff with the right mix of skills and experience to ensure its success and sustainability. The Scottish Government should ensure that the Bank can offer employment and remuneration terms which are sufficiently competitive to attract suitably skilled and experienced people.

Recommendation 21: The Bank should adopt a leadership role with regards to diversity and inclusiveness within its governance, operational arrangements and investment strategy.

[22] Macfarlane, L. and Mazzucato, M. (2018), "State investment banks and patient finance: An international comparison", UCL Institute for Innovation and Public Purpose Working Paper, IIPP-WP 2018-01

Appendices

Appendix A Terms of reference

In September 2017, SG announced within the Programme for Government that it would begin work to establish a Scottish National Investment Bank. The First Minister subsequently asked Benny Higgins, the CEO of Tesco Bank, to lead the work on developing the Bank's remit, governance, operating model and approach to managing financial risk. Mr Higgins convened an Advisory Group of experts to support him in the development of this plan. In addition to the support from Scottish Government staff, membership consists of the following individuals:

- Paul Brewer (Former Corporate Finance Partner, PwC LLP)
- Paul Lewis (Interim Chief Executive, Scottish Enterprise)
- Professor Mariana Mazzucato (Director of the Institute for Innovation & Public Purpose, University College London)
- Alan McFarlane (Senior Partner, Dundas Global Investors)
- Peter Reekie (Chief Executive of Scottish Futures Trust)
- Liz Ditchburn (Director General Economy, Scottish Government)
- Alyson Stafford (Director General Scottish Exchequer, Scottish Government)
- Gary Gillespie (Chief Economist, Scottish Government).

This Implementation Plan describes the conclusions reached by Mr Higgins and the Advisory Group and makes recommendations about how SG should proceed with establishing and capitalising the Bank, what the Bank's functions and structures should be, the relationship that the Bank should have with SG and existing financing agencies and interventions.

In addition to a commitment to establish the Bank last September, the First Minister set out Terms of Reference for the development of this Plan to guide the work of the Advisory Group and the Outline Business Case which accompanies this report.

The Terms of Reference are set out below, including the Implementation Plan section reference to ease cross reference of key sections.

Terms of Reference	Implementation Plan Section Reference
Evidence of market failure and business case	
The implementation plan will be underpinned by analysis of the evidence on market failures, and appraisal of potential solutions to ensure that the bank has the maximum impact on the Scottish economy. In particular this should set out how displacement will be minimised and additionality maximised by the proposed approach. This should consider the potential scope of the bank in the widest sense drawing on this to inform its view on scope.	The need for a Scottish National Investment Bank
The plan will be based on engagement with key stakeholders in finance, the wider business community and civic Scotland to gather views on the merits of potential delivery models and approaches and their likely effectiveness in stimulating additional investment.	Initial focus for investment activities

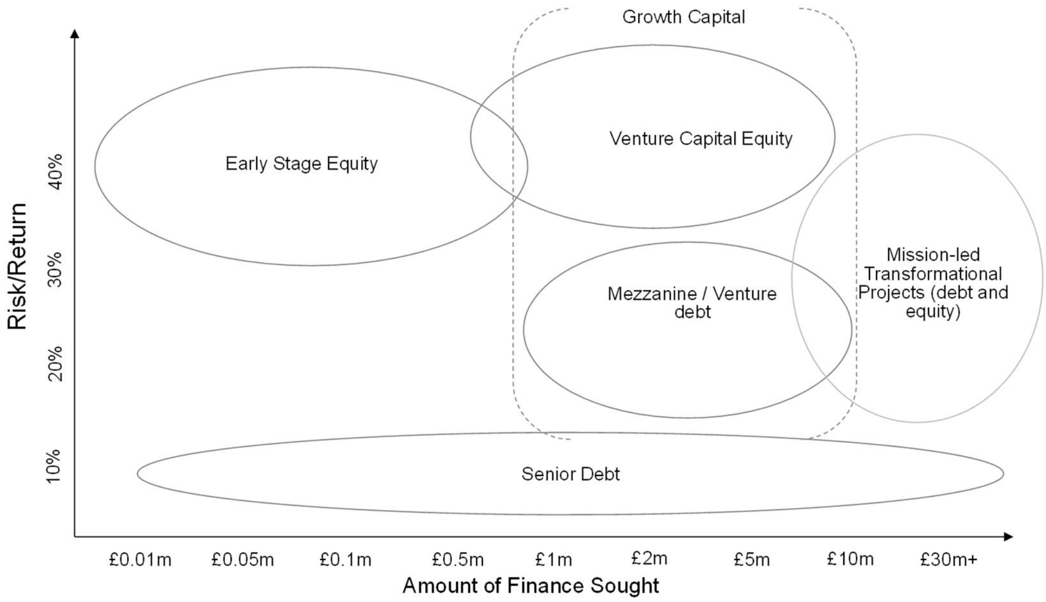
Terms of Reference	Implementation Plan Section Reference
It will develop the aims and objectives for the Scottish National Investment Bank, drawing on work from the Council of Economic Advisers and elsewhere and seeking to maximise the contribution to the long-term growth of the Scottish economy. This will include whether the activities of the bank should be focused exclusively on the private sector or whether there is also scope to secure value in delivering new approaches to public sector financing.	The need for a Scottish National Investment Bank
The final report should take a wide view of market failure and consider how this can be addressed by the bank, e.g., not just the quantum of business finance but also how the bank's scope of activities, and involvement both direct and indirect, might impact on improving conditions attached to finance for both businesses and infrastructure investment.	Initial focus for investment activities
The final report should consider whether the bank should interact directly with business or through intermediaries. It should also consider the market for finance should it be limited to SMEs, wider business or include the public sector, in which case how would it complement existing sources of public finance.	Initial focus for investment activities
Governance	
Propose a governance model for the SNIB to ensure effective oversight and accountability in the delivery of the aims and objectives, and in particular ensure that the governance addresses the relationship with Scottish Ministers and the Scottish Parliament. Whether or not this is best delivered in the public or private sectors should be considered as part of the plan.	Governance arrangements
Working with SG Finance, consider the implications of the proposed governance model for National Accounts classification of the SNIB and consequently any questions that would need to be addressed with UK Government about its operation within budgetary rules.	Classification and capitalisation of the Bank
Identify how the bank could operate within the current rules setting out what it could do and what it could not do. Make a clear case as to where any existing budgetary rules have the unintended consequence of forcing a National Investment Bank to operate in a sub-optimal manner and the advantages that could be gained from any changes.	Initial focus for investment activities
Consider how the SNIB would relate to existing bodies, initiatives and funding streams which support infrastructure, business investment and innovation, and if appropriate where these might be consolidated within the SNIB.	Fit with the existing public sector financing landscape

Terms of Reference	Implementation Plan Section Reference
Operating model	
Develop a Target Operating Model for the SNIB to support recruitment of appropriately experienced staff and establishment of other aspects of the SNIB operations.	Transition plan
As part of considering the Target Operating Model, set out initial principles for the SNIB to ensure robust management of financial risk.	Transition plan
Capitalisation	
Drawing on discussion with SG Finance, the report should propose a capitalisation plan over an appropriate number of years to allow the Bank to operate effectively.	Classification and capitalisation of the Bank

Appendix B Financial products

The risk and return profiles are considered below in the context of the Bank establishing a balanced portfolio.

Figure 9: Illustrative risk and return profile for financial products



These benchmarks can only be a guide. As the Bank develops its Business Plan and starts to invest, its management should adapt its strategy to the requirements of the market and to add value as well as making a return. In addition, while target returns can be established in the short-term, the actual return will not be apparent for several years, although there will be indications of the performance of both debt and equity.

An explanation of each investment and the expected returns are detailed below.

Investment class	Expected returns
Early stage equity	Medium to long-term investment with return in the form of proceeds of selling the equity on exit. Overall return will be net of the Bank's costs of running the equity investment programme (eg, investment managers, commercial advisors) and the costs of investment failure (as risk capital, failure risk for this investment category is relatively high). Target return for each investment in the region of 30-50%, in order to generate an overall blended target return for the investment class of 10%, being investment returns net of running and failure costs. The British Private Equity and Venture Capital Association ("BVCA") benchmarking[23] indicates an average range IRR of 9.8% from this investment class.

[23] https://www.bvca.co.uk/Portals/0/Documents/Research/Industry%20Performance/2016-Performance-Measurement-Survey.pdf

Investment class	Expected returns
Mezzanine finance	Medium-term investment with return in the form of interest, and, often at the end of the term, repayment of the principal amount. Interest will either be capitalised or paid in cash during the period of the loan, or a combination of both. A variable share in the business upside may also be received through either an equity warrant or a profit/growth levy or redemption premium equating to a percentage of the loan amount. Overall return will be net of the Bank's costs and the costs of investment failure (whilst mezzanine debt has priority over equity, it is subordinate to senior debt). The BBB identified a target return in the region of 8-20%[24] may be appropriate. This would accommodate an overall blended target return for the investment class of 10%, being investment returns net of running and failure costs.
Venture capital	Short to medium-term type of private equity, provided to small, early-stage, emerging firms that are deemed to have high growth potential or have demonstrated high growth to date. Venture capital generally comes from venture fund managers, high net worth individuals, investment banks and any other financial institutions. The early stage nature of these investments are often inherently risky which is reflected in the often high rates of return sought on investments. Levels of returns and losses are akin to early stage equity outlined above.
Subordinated debt	Short to medium-term investment with return in the form of interest and, often at the end of the term, repayment of the principal amount. Overall return will be net of the Bank's costs and the costs of investment failure (has priority over equity, but is subordinate to senior debt). Coupon price will reflect the risk of each specific investment. Target return 10-15% to generate a blended target return of 10%, being investment returns net of running and failure costs.
Senior debt	Short to long-term investment with return in the form of interest and, more than likely a combination of regular and one off payments at the end of the term, to repay the original principal amount. Low margin investment, so risk tolerance is also low. The Bank would aim to limit any failures to around 2% to avoid the investment class making a loss overall.

[24] https://british-business-bank.co.uk/wp-content/uploads/2015/03/Growth-loan-research-report-FINAL-VERSION.pdf

Appendix C Existing sources of finance

Scottish Government

SME capital

The **Scottish Growth Scheme** is a £500 million package of financial support backed by the Scottish Government to help businesses grow. The Scheme currently has two elements: the Scottish-European Co-investment Programme, providing a package of £200m investment into SMEs; and new and additional funding for the SME Holding Fund – a £25m expansion which will lead to £100m invested in SMEs.

The **SME Holding Fund** is a “Fund of Funds” initiative managed by the Scottish Government, financed by European Regional Development Fund, which addresses gaps in Scotland's finance sector for those SMEs with growth and export potential, by part-funding a number of investment vehicles managed by appointed Delivery Agents. These DSL Business Finance which provides up to £25,000 to micro businesses under the Scottish Microfinance Fund; Business Loans Scotland, a consortium of Scottish Local Authorities with an in-house Fund Manager, which provides loans of up to £100,000 to SMEs; and, Scottish Enterprise, through its Scottish Co-investment Fund and its Scottish Venture Fund which provides early stage equity risk capital up to £2m and within a deal ceiling of £10m to SMEs with high growth potential.

Housing and regeneration financing

The **SPRUCE** is the ‘brand name’ for the Scottish JESSICA Initiative (Joint European Support for Sustainable Investment in City Areas). It is an evergreen fund originally co-financed with £50m from SG and EU funds and managed by the EIB. Amber, a private sector fund manager seek to secure investments aligned to an agreed investment strategy for which there is a mandate to 2021. The ethos of the strategy is to ensure that SPRUCE can effectively contribute to and marry up with regeneration projects which are consistent with Scottish Government objectives and locally driven policies right across Scotland. The fund is focused on supporting revenue generating projects that support urban regeneration. All investments have a requirement for the recipient to deliver community benefits.

The £40m **Infrastructure Investment fund** (2017-18) is intended to finance and enable site preparation, installation of essential services and unlock stalled locations so that additional housing can be built provides both debt and equity finance. As the Housing Infrastructure Investment programme matures, an increasing focus is on growth areas and regeneration commitments which are regional economic priorities within City Deal delivery plans.

In the **private rented housing** sector, Government guarantees, loan investments and PWLB borrowing consents are supporting successful and innovative private sector vehicles in the delivery and scaling up of new house-building for affordable and market rent provision, unlocking key sites and attracting large scale private investment. As expansion progresses towards over 10,000 homes across these programmes, new investments are, wherever possible, seeking to raise quality standards and demonstrate how increased social value can be achieved from housing investment.

Home ownership support schemes provide equity financing to assist home-buying. £70m is available in 2017/18 for SG’s Open Market Shared Equity scheme (OMSE) to help up to 1,700 first time buyers on low to moderate income; and £65m is available this year for the Help to Buy (Scotland) Affordable New Build and Smaller Developers Schemes to help up to 2,200 households.

Scottish Enterprise

The **Scottish Investment Bank (SIB)** is the investment arm of Scottish Enterprise. It fills a number of the functions of other international National Investment Banks within Scotland but its scope and scale is significantly less than sought for the Scottish National Investment Bank.

SIB's remit is supporting the growth and development of Scotland's early stage risk capital market operating as a market gap funder. A key part of the remit is to generate positive economic impact whilst investing on a commercial basis. SIB's remit has expanded over recent years, continuing the innovative, and now established, co-investment approach with a number of new interventions delivered aimed at improving the opportunity for companies to access available funding. All interventions are designed to lever significant private sector funding. Current financial products provided by SIB includes:

Early stage capital (up to £2m)

The **Scottish Co-Investment Fund (SCF)** and **Scottish Venture Fund (SVF)** – are equity co-investment funds, part-financed by the European Development Fund through the SME Holding Fund, designed to stimulate early stage risk capital investment into high growth potential Scottish companies across a range of sectors given the strong evidence of a long term, systemic market gap constraining company and therefore economic growth. The funds invest up to £2m within a ceiling of £10m, are private sector investor led, catalysing investment into high risk opportunities by sharing the risks (and rewards) with investors where there is an investment gap in a deal.

Growth capital (£2m-£10m)

The Scottish European Growth Co-investment Programme was developed to support companies' growth and scale up given the lack of available growth capital identified. This innovative programme (the first to be developed in Europe) is a £200m mechanism, £50m of capital commitment from Scottish Enterprise (provided by Scottish Government under the Scottish Growth Scheme) is matched £50m from the European Investment Fund and £100m of private sector capital from a range of UK and European Venture Capital Funds invested in by the European Investment Fund.

Sector support

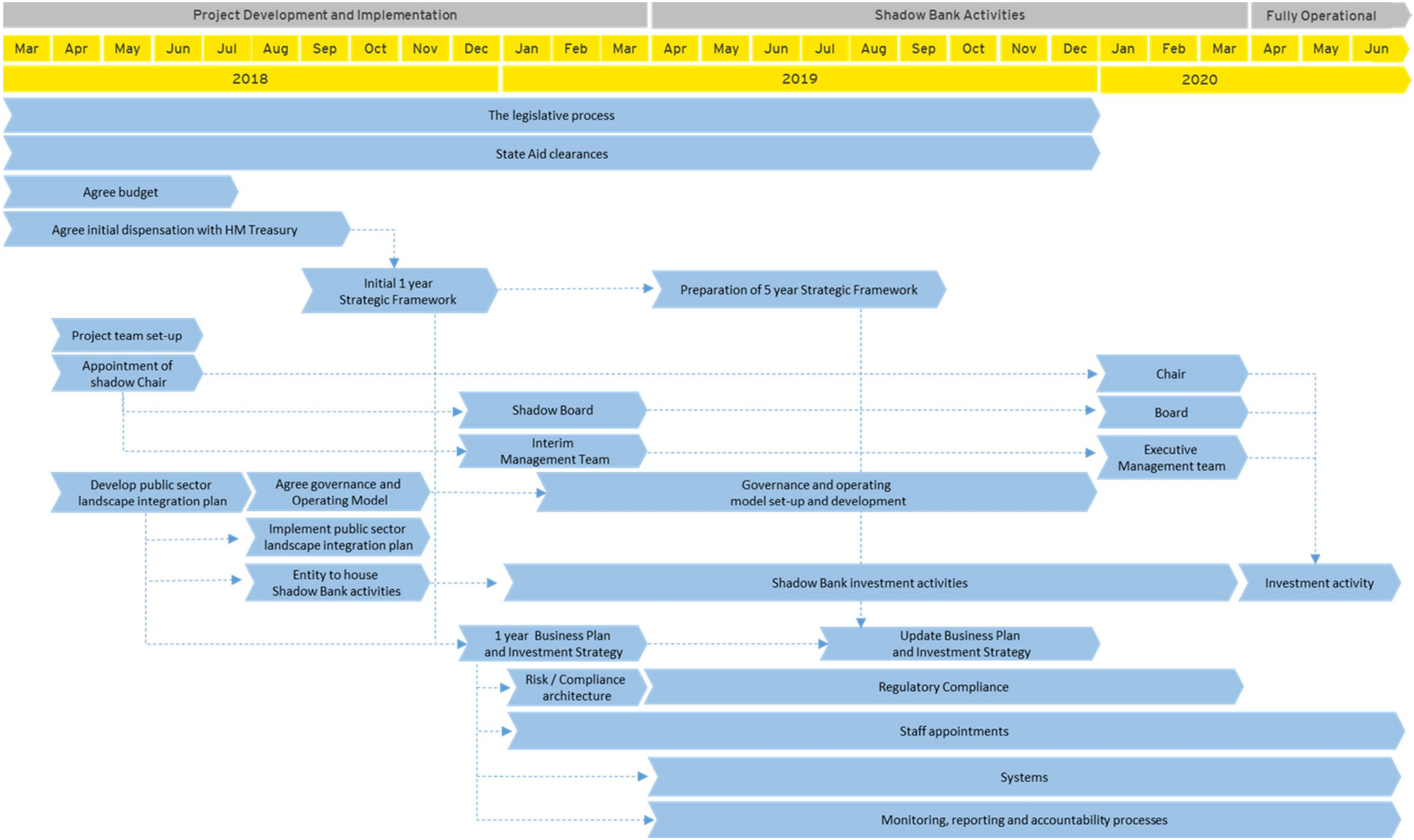
The **Renewable Energy Investment Fund** is delivered by the SIB on behalf of Scottish Government. This fund was created to support Scottish Government's mission to increase energy delivered from renewable sources, reducing the costs of renewable energy and increasing community ownership and development of renewable energy projects. The Fund invests via equity and loans, the Scottish Investment Bank team curates and structures complex deals supporting the development of a new funding market under Scottish Government's low carbon policy agenda. This Fund transitioning during 2018/19 into a wider focused Energy Investment Fund.

SIB invested £5m alongside a range of other Limited Partners into a £50m life sciences fund based in Scotland, Epidarex LLP, to stimulate higher levels of early stage funding to one of Scotland's key sectors. This fund invests in and promotes the commercialisation of ground-breaking research and new technologies to address large and unmet needs in today's healthcare market.

Debt finance

The SIB provides financing of up to £2.75m through an innovative funding model to stimulate growth in a Scottish based Peer 2 Peer lender, the Lending Crowd, adding to diversity and choice for companies struggling to raise debt.

Appendix D Transition plan summary timeline



Appendix E Business plan contents

The table below identifies and describes the key sections of the Business Plan.

Sections and components	
State Aid and regulatory clearance	• Progress on State Aid Clearance for market activities. • Progress on regulatory clearance – work through necessary asset clearance with Financial Conduct Authority with the FCA.
Operating model and legal entity	• Building on work by the Scottish Government, further work on the Bank's operating model and organisation structure, including establishment of any necessary subsidiaries, their staffing and purpose. • The existing landscape element to identify how current activity will be encompassed within the Bank • The Bank's recruitment needs and a recruitment plan, remuneration policies and structures. • Identification of temporary premises for newly appointed Management Team as well as permanent premises for when wider team is employed.
Market access	• Initial suite of products/funds and investment activity that the bank would operate in order to respond to SG's Strategic Framework for the Bank. • Target firms for these products and how the bank would find customers and how investments would be made, including investment through funds and other financial intermediaries. • What structures and staff are necessary within the Bank to support these activities.
Portfolio strategy	• Strategy for establishing portfolio of assets via the products set out above and expected returns and profile of returns. • Profile of investment and fit with budgetary support from the Scottish Government. • Asset management strategy including management and sale of equity investments/fund investments and recycling of capital. • Incorporation of any legacy assets and legacy funds or investment programmes, and plans for how these would be accounted for in the Bank.
Financial	• Financial controls and systems necessary for making investments and handling of returns including from debt holders.
IT architecture	• Identification of suitable systems and applications to support investment/asset management. • The process for becoming 'IT ready', e.g., set up of email domains and procurement of necessary systems in other areas.
Risk management and compliance	• Consideration of risk management and compliance frameworks, systems and controls, as well as identifying responsible owners. • Consideration should also be given to how data will be managed.
People strategy	• Strategy for staffing the Bank, including what staff are necessary, remuneration and conditions, fit with investment strategy. • On-going development of staff as the Bank is established. • Practical considerations for staff – location, IT, pension arrangements, etc.
Monitoring and reporting	• Identification of key performance indicators and governance/reporting, both internally and externally. • How the report and relationship will work with the Advisory Board and Scottish Government, including any data sharing and confidentiality agreements necessary.

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Scottish Government
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Any enquiries regarding this publication should be sent to us at
The Scottish Government
St Andrew's House
Edinburgh
EH1 3DG

ISBN: 978-1-78851-660-0 (web only)

Published by The Scottish Government, February 2018

Produced for The Scottish Government by APS Group Scotland, 21 Tennant Street, Edinburgh EH6 5NA
PPDAS358886 (02/18)