

RSE RESPONSE TO SCOTTISH NATIONAL INVESTMENT BANK CONSULTATION

Summary

- *The response follows continued engagement from the Royal Society of Edinburgh (RSE) with Scottish Government officials and the Implementation Group over the past year.*
- *The response by the Society to the first consultation on the Bank last year is used as a basis for our key concerns and considerations. The response in 2017 highlighted our support in principle of the development of the Bank but also our concerns. The Implementation Plan was broadly supported by the RSE and the accepting of the recommendations by Scottish Government was welcomed.*
- *However, there are some concerns regarding the objectives, operational focus and governance which the Society believes need to be addressed.*
- *It is recommended that there should be only a small number of objectives, with the main objective being to add to the amount and quality of investment in Scottish business, to the benefit of Scotland's economy. Other objectives may relate to filling gaps in supply of funds in areas where input by the Bank is worthwhile and would enable it to meet its return on capital requirements. These objectives should be part of a Strategic Framework which should be clear and succinct. All objectives should be measured by key performance indicators and returns on investment.*
- *As noted in the 2017 response the RSE believe that one of the biggest issues is the demand for capital rather than supply. However, there are still gaps that the Bank could address such as helping businesses to scale up, and/or providing a level of advice and support to businesses to help stimulate demand.*
- *There is a risk of duplication and the RSE would strongly recommend that the Bank does not compete with other organisations such as the British Business Bank or existing investors in the private sector. The Bank should not support the development of large scale critical infrastructure as this function is already carried out by other arms of government.*
- *There are concerns over the governance of the Bank, as it is not clear what inputs and outcomes are expected from a separate advisory board, and this may add a complexity that is not necessary. The Bank will require clear guidance and should be subject to regular and in-depth monitoring and evaluation; but interference in decision-making and day-to-day operations should be avoided. The RSE is keen to continue to provide assistance when necessary in the development of the Bank.*

Introduction

- 1 The RSE welcomes the opportunity to respond to the Scottish Government consultation on its updated proposals for the Scottish National Investment Bank. (For the purpose of this response the Scottish National Investment Bank will be referred to as 'the Bank'). This follows on from the response that the Society produced last year to the initial consultation, which, as is the case with this response, was facilitated through our Business Innovation Forum (BIF). The Forum is a standing committee of the RSE which is chaired by Professor Iain Gray with Professor Jeremy Peat as Deputy Chair. The BIF brings together key business stakeholders and academics with backgrounds in business, economics and finance.

- 2 As our response in 2017 noted¹, the BIF has previously (in 2014) examined the supply of capital to a specific segment of the SME base in Scotland, in collaboration with ICAS and Scottish Financial Enterprise².
- 3 In producing our response last year, the RSE consulted the Implementation Group led by Benny Higgins between two meetings in which our response was discussed. This served to improve the Society’s understanding of the objectives and processes included in the implementation plan. Since the publication of our response, the RSE has continued to be engaged with the process, meeting senior representatives from the Scottish Government economic unit, the Enterprise and Skills Strategic Board and the Implementation Group.
- 4 On learning of the next steps for the development of the Bank, and the new consultation, engagement has continued. The Forum met with David Wilson in the opening weeks of his role as Director for the Bank. This led to a roundtable discussion at RSE on the consultation document and future developments involving members of the Forum, David Wilson and colleagues, and some other informed and interested parties. This discussion has helped to shape this response.
- 5 Our response in 2017 welcomed in principle the development of the Bank but at the same time asserted our concerns and emphasised a range of points that would need to be considered before plans for the Bank were finalised. These included concerns regarding the financing and capitalisation of the Bank; areas of intervention/operation; the ‘mission-oriented approach’; staffing; and governance. We also stressed the need for clarity regarding the Bank’s relationship and interaction with other agencies and bodies, at both Scottish and UK levels, which currently operate in some areas also to be covered by the Bank according to its proposed remit.
- 6 The Implementation Plan, published in February, had clearly considered many concerns and considerations arising in the consultation process. Many of the recommendations that were presented within the plan were strongly welcomed and supported by the RSE. Indeed some of these were related to the concerns set out in our response. The Society reiterates our support, in principle, for the Bank; and in particular for its aim of increasing the quantity and quality of business investment in the Scottish economy and supporting growing businesses.
- 7 However, there is still concern over the remit and operation of the Bank on the points laid out in the consultation document. Within that document it seems that there still remains some lack of clarity over objectives as well as uncertainty on what the Bank will focus on, how it is to be run and how it will operate alongside agencies (including the enterprise agencies), businesses and commercial banks; and indeed, alongside the British Business Bank.

Objectives and Instruments

- 8 The RSE believe that one of the main issues will be the careful specification of the objectives as these will be crucial to the operational success of the Bank.
- 9 In simplest terms the main objective must be to add to the amount and quality of investment in Scottish business, by operating in areas which add significant value, as related to the Scottish Government’s over-arching objectives for the economy and do so without replacing or adversely affecting the demand for existing and other potential sources of finance from the private or public sectors. At the same time the Bank must achieve an adequate financial return on its investments, such that the returns on investment can be re-invested and the Bank achieves stability and sustainability.
- 10 This implies that the Bank may need to miss out on some opportunities where there would be strong returns and avoid others which appeal at first blush but prove unsuitable for a source of funds seeking to achieve a distinct positive return on investments.

¹ Royal Society of Edinburgh, (2017) ‘Scottish National Investment Bank’. URL: <https://www.rse.org.uk/wp-content/uploads/2017/11/RSE-Response-to-Scottish-Government-Scottish-National-Investment-Bank-Consultation-API7-27.pdf>

² The Royal Society of Edinburgh (2014), ‘The Supply of Growth Capital for Emerging High-Potential Companies in Scotland’; URL: <https://www.rse.org.uk/advice-papers/the-supply-of-growth-capital-for-emerging-high-potential-companies-in-scotland/>

- 11** There is a view in the business and financial community that significant amounts of business investment do not take place because of a lack of demand rather than supply constraints. The SMEs involved may be wary of accessing funds from some sources and not well briefed as to the funds which would be available in a form suiting the investment proposed. This is at a time when a number of banks operating in Scotland claim to have substantial funds available to invest in viable opportunities.
- 12** The Bank could serve a very valuable function by markedly reducing the extent of discouraged investment of this type, not by investing itself but by assisting companies to access funds from other, appropriate and available, sources. Sometimes co-investment by the Bank alongside other sources of funds may be appropriate.
- 13** It may be a rare occasion where the investment is sufficiently robust to merit Bank investment, but funds from other sources are, for one reason or another, not available. In such instances investment by the Bank would be ‘additional’ and should yield an acceptable return.
- 14** There will be other potential investments where the risks are too high for the Bank; and/or the likely returns too low. Even if such investments fit in with a mission of the Scottish Government they would not be suitable for investment by the Bank. In such cases the Government should consider investment via (for example) its enterprise agencies. We suggest the same should apply to possible investments in failed or failing companies. If the private sector is unwilling to intervene it is unlikely to be suitable for the Bank to do so. However, some combination of wider or very much longer-term factors may make enterprise agency engagement a possibility for consideration.
- 15** There is a narrow gap here for the Bank’s involvement – between on the one hand circumstances where the private finance sector will, or can be induced to, intervene appropriately; and on the other hand, instances where risks and the probability of low and/or very belated returns make the investment unsuitable. It will be a major challenge for those operating the Bank to identify such opportunities.
- 16** Given the above, the RSE would suggest that the Strategic Framework, which will largely determine the objectives and mechanisms of the Bank, needs to be crystal clear and succinct with a limited number of carefully selected objectives. If this aim is not realised, then there is a significant risk that the objectives may become a wish list that the organisation will struggle to achieve.
- 17** It will be important for all objectives to be measured by transparent Performance Indicators, related to objectives, and return on investment targets. By way of example, the British Business Bank (BBB) is required to make the same return on capital employed as medium-term government costs of capital which is currently 2.25%.

Where Are the Gaps?

- 18** In our 2017 response, the RSE highlighted that the supply of capital was not the main issue in Scottish and UK markets, but we accept that there are still gaps and room for improvement. The supply of capital in Scotland has increased. Latest research from the BBB shows that that Scotland’s equity finance market has increased with the amount of equity investment in Scottish companies up to £191m in 2017. This is an increase of 100% from 2016.
- 19** Further, banks in Scotland have increased their support for SME lending in the last year, Clydesdale Bank lent £451m to Scottish SMEs in 2017, beating their target of £400m, and committed to lending a further £6bn across the UK over next 3 years³. HSBC recently increased lending to Scottish SMEs by £650m⁴.
- 20** The BBB have now been operating in these areas for 4 years. The Society would strongly encourage the Bank to work closely with the BBB.

³ Clydesdale and Yorkshire Banking Group (2018). ‘Challenger Bank CYBG Ups Lending to UK SME’s’. URL: <https://www.cybg.com/media-relations/our-work-with-sme/2018/challenger-bank-cybg-ups-lending-to-uks-smes>

⁴ HSBC (2018), ‘HSBC Launches £10bn Fund to Support UK SME’s’. URL: <https://www.about.hsbc.co.uk/-/media/uk/en/news-and-media/cmb/hsbc-launches-10bn-sme-fund.pdf?la=en-gb&hash=571090395645ABA67749AD0AE943F3988D13BEA9>

- 21** Scaling up is an issue in Scotland particularly for SMEs. Scotland is still very short of Venture Capital (VC) funds with the credibility and capital to lead rounds of the size required to anchor the HQs of promising companies to drive global growth. This often results in SMEs being bought out, with very few keeping operations and HQ's in Scotland. A possible role of the Bank would be to address this gap, providing additional support to SMEs to scale up. This would require developing a mechanism which would help angels/investors exit once the company is ready to scale up. Additionally, the Bank could also come up with additional incentives and/or support beyond co-investment to attract VC teams to relocate and/or fundraise in Scotland. The example of Epidarex Capital opening offices in Edinburgh proves that it can be done.
- 22** As mentioned above the main issue within this marketplace may not be the lack of supply of capital in Scotland but rather the demand for capital from SMEs. The Society would highlight that one of the biggest problems for SMEs is the lack of understanding of the various sources of capital and the appropriateness of different capital instruments. Therefore, advice and information provision to the SME sector is required; this is a role that could be fulfilled by the Bank alongside the enterprise agencies.

What SNIB shouldn't do

- 23** There are many players active in the areas discussed in the consultation document. It is therefore critically important for the Bank to work with these organisations as partners and not competitors. Perhaps the most important such organisation is the BBB, with whom a close relationship from the outset must be essential.
- 24** The RSE believes that the Bank should not support the development of large scale critical infrastructure. This is a function already carried out by the Scottish Government and the Scottish Futures Trust.
- 25** As mentioned above the proposed 'mission oriented' approach raises concerns with the RSE. Over past decades 'picking winners' has not proved a successful strategy for governments in the UK. Following this route without very careful analysis, including a full risk assessment, could lead to the Bank investing in businesses which may be fashionable and indeed potentially strategic but in which Scotland has neither comparative advantage nor any reasonable chance of achieving cost-effective manufacturing at scale. Some we have consulted suggest that the focus should rather be on high-value components/sub-systems, that are less capital intensive and in which Scotland does have something globally competitive to offer.

Governance

- 26** The Governance of the Bank will be crucial to its success and operation. This is an area in which the RSE has considerable concerns.
- 27** In developing the governance structures of the Bank, the performance of Scottish Government in the governance of other public bodies, agencies and institutions needs to be reviewed. During our round-table discussion some examples of inadequate governance were noted such as the reorganisation of Scotland's Further Education Colleges and the failures at several regional NHS Boards. The consideration of governance should include the precise relationship between the Bank and Government. The Bank will require clear guidance and should be subject to regular and in-depth monitoring and evaluation, but interference in decision-making and day-to-day operations should be avoided.
- 28** The consultation document states "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 Scottish Government".

- 29** RSE support this objective and intention. It also supports the processes detailed in the consultation document in relation to the appointment of Chair, Non-Executive and Executive Directors of the Bank. The consultation posits that there should be a board of 8-12 people with two thirds being non-executive directors. The RSE would encourage the Government to agree with the Chair and Chief Executive at an early opportunity the skills, experience and expertise that will be required around the Bank board table to ensure that it achieves its business objectives while providing assurances to Scottish Government that the Bank is aligned to the missions established by Scottish Government. This will be essential if it is to attract the calibre of personnel required to successfully establish the Bank and meet the Government's desire that it operates on a commercial basis, independent of Scottish Government and to the highest investment management standards. The governance arrangements for the Bank should adopt best practice drawn from the investment bank world and not seek to create new mechanisms that may have the unintended consequence of frustrating the Bank's ability to make robust investment decisions without undue influence or control from Scottish Government.
- 30** Similarly, the consultation suggests that an 'Advisory Group' should be established by the Bank, although the detail suggests that this Advisory Group would in fact be established by the Scottish Government and advise Scottish Ministers on the performance of the Bank. It is entirely for Ministers to determine how they will monitor performance, but we have concerns that the Advisory Group, particularly if its membership includes a Non-Executive Director of the Bank, could develop into a 'shadow Board' of the Bank which may create conflict and cloud governance arrangements.
- 31** If the Bank's Board is constructed using a skills matrix as detailed above, the RSE would not see the need or purpose for an Advisory Group. We believe that there is current capability within Scottish Government already through its various councils and analytical units to provide assurance to Scottish Ministers on the performance of the Bank, beyond the usual methods of audit. There may be occasions when the Government and the Bank may agree on the creation of a short term working group to cover some specific issue or issues. One of the key objectives of any Board or Chief Executive is to ensure that arrangements are in place for stakeholder engagement and the Bank should be allowed to develop its own arrangements post establishment, rather than Government attempting to allow for stakeholder engagement through a permanent Advisory Group.
- 32** If the Bank is to aspire to be a £2billion bank playing a key role in enhancing productivity and transforming the Scottish economy, there must be an unambiguous remit from Government, very clear reporting lines and well-defined board responsibilities. The choice of chair, the mix and experience of board members and the need to ensure that the Board is demonstrably independent and free from vested interests, will all be crucial.
- 33** Whatever framework is arrived at the RSE would recommend that the Scottish Government and the Bank enter into a relationship agreement on the establishment of the Bank, which would agree and document the governance relationship between Government and the Bank rather than enshrine it in legislation, to allow amendments to take into account developments in best practice.
- 34** The RSE stand ready to further assist the Scottish Government in the development of governance arrangements for the Bank. We are ready to provide advice based upon significant and broad-based expertise and experience that we believe will help to develop governance arrangements that would support the overall success of the Bank.

Conclusion

- 35** In closing this response, the RSE wish to / re-emphasise our strong support for any measures which can help stimulate further and more effective business investment in Scotland. We fully accept that achieving this end is critical to stimulating productivity and achieving stronger and more sustainable growth. This in turn is essential to achieve the Scottish Government's objectives of more balanced and more widely spread benefits from economic advancement.
- 36** However, we also wish to emphasise that the proposed Bank should not be seen as a universal panacea. As we have emphasised at the round-table and throughout this submission, investments will have to be chosen with care if they are to add real value to our economy. On the one hand these investments should not simply displace appropriate investment which would have been available from other sources; whilst on the other the Bank should avoid investing in activities which cannot be expected to earn an acceptable return, however worthy the cause involved.
- 37** To achieve the desired success in this complex and crowded market the Bank must co-operate with other players, by no means least the BBB and the enterprise agencies; and it must pick its investments with care to achieve additionality and generate strong value added.
- 38** This will in turn require strong and diverse skills amongst its staff and fully appropriate governance, avoiding undue interference from both Government and other vested interests.

Additional Information

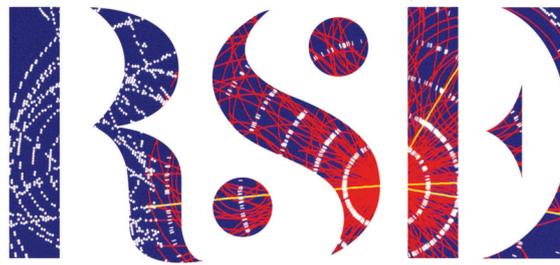
This Advice Paper has been signed off by the General Secretary of the RSE.

Any enquiries about this Advice Paper should be addressed to Mr Paul Stuart
(email: pstuart@theRSE.org.uk)

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