Labour's
Policy
Review

The Case for a British Investment Bank:

A Report for Labour's Policy Review

by Nick Tott

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The Case for a British Investment Bank

A Report by Nicholas Tott

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Foreword

In December 2011 I was commissioned by Ed Miliband MP, Ed Balls MP and Chuka Umunna MP to examine the case for a British Investment Bank. I was pleased to accept because after working for many years on infrastructure investment and business financing I believe that there are significant and long-standing problems in the UK. These need to be addressed given the importance of fit-for-purpose infrastructure and a successful, growing Small and Medium-Sized Enterprise (SME) sector to the economy.

When I embarked on my task I said that my guiding principle was to 'create effective solutions not grand institutions'. My review has convinced me of the benefits of having an institution focused on addressing infrastructure investment and SME financing. I also believe that the long-standing problems in infrastructure investment and business finance have been exacerbated by the financial crisis, the return of recession and changes to regulatory rules in the banking and insurance sectors, and that these have made the case for some form of British Investment Bank even stronger. I hope that this report will help provide a route map to the creation of a growing economy in which business enterprise has the wherewithal to flourish.

The conclusions I have come to are my own. They are not those of the Labour Party. However, I hope that they will be considered carefully by the Party because there are options, based on international experience, for tackling some of the significant and long-standing problems in the UK which my report identifies.

Introduction

For some time the calls have increased and grown louder for the creation of some type of government-backed financing institution to support the UK economy. The development of the Green Investment Bank in the UK, albeit with limited powers so far, has offered a model and lessons on how an investment vehicle can be established. But under the umbrella title of 'British Investment Bank', many different structures achieving many different ends are put forward. The purpose of this report is to assess the case for the creation of an entity based not only on the needs created by the perfect storm we have been experiencing since 2008 but also on a wider assessment of the intrinsic value which a permanent institution could have for UK plc throughout the economic cycle and to address issues which existed before the crises which have occurred since 2008. I examine a range of different issues in the UK economy which a British Investment Bank might address, and various international models which deal with similar issues in other countries.

Investment in infrastructure and innovation to develop a low-carbon economy has to be a key part of any British Investment Bank. This report also assesses the extent to which market failures and gaps exist, in the financing of SMEs and the financing of infrastructure beyond that already covered by the Green Investment Bank.

Any British Investment Bank must operate in a commercial manner to ensure that investments and interventions are made on a rational basis, only supporting viable businesses with a proper analysis and pricing of risk. All lending should be in addition to, or in partnership with, private lending. This is important where the intervention is designed to fill a gap which the market is not providing. Interventions must be based on sound credit decisions not on a 'finger in the air' picking of winners or support for businesses which will never be profitable. We can learn from the establishment of the Green Investment Bank, where its role is to 'crowd in' investment, operating commercially and making sound investment decisions which is vital in creating a subsequent market appetite by demonstrating the soundness of the proposition.

Part 1: Financing Small & Medium Sized Enterprises

The bedrock of the UK economy is the SME sector. A vibrant growing SME sector is one of the prerequisites for future growth in the UK economy. The majority of new jobs created in the UK are created by small businesses – existing small businesses contribute 34% of new jobs created, whilst new business start-ups contribute 33%.[1] Addressing the financing needs of this sector is a vital component of economic growth. In addition, delivering infrastructure investment requires a properly functioning supply chain, predominately comprising SMEs.

However, there are a number of market failures[2] affecting the supply of finance to SMEs. These market failures relate to the provision of both debt and equity. There is also a demand-side issue relating to the awareness of businesses as to the potential benefits of raising finance or the chance of doing so successfully. That lack of sophistication may be resulting in businesses failing to exploit their growth potential.

Financing Gaps

The non-availability of finance to smaller businesses is long-standing. It was identified in 1931 by the Macmillan Report[3] (such lack of finance being known as the 'Macmillan Gap'). Market failure is caused by an asymmetry of information between debt provider and business borrower. Lenders find it difficult to distinguish between high and low risk businesses without incurring significant costs. Lenders seek to avoid those costs by basing the decision to lend on evidence provided by the borrower as to its track record and/or the provision of collateral. This obviates the need to assess whether the business is economically viable. This may also be exacerbated by the effects of credit scoring systems which are designed to reduce information costs and improve the quality and consistency of lending decisions but which may increase the likelihood that firms with atypical businesses in higher risk, cutting-edge areas, fail to secure loans. Information asymmetry thus has three manifestations:

- loans at a higher rate than the risk-adjusted rate
- loans subject to over-collateralisation
- outright rejection of the loan application[4]

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1 Job Creation and Destruction in the UK: 1998-2010 (Anaydike-Danes, Bonner and Hart – Aston Business School, October 2011).

2 Defined as "an imperfection in the market mechanism that prevents the achievement of economic efficiency" HM Treasury Green Book: Appraisal and Evaluation in Central Government (2003) p103; BIS Economics Paper No 16: SME Access to External Finance (January 2012) Section 2.

3 Report of the Committee on Finance and Industry, Cmd 3897, July 1931.

4 See Information Asymmetry, Small Firm Finance and the Role of Government, J Lean, J Tucker, University of Plymouth Business School: Journal of Finance and Management in Public Services, Volume 1 Summer 2001 pp43-60.

There is also a relative lack of competition in mainstream credit providers. The Independent Commission on Banking identified that the largest four banks account for 85% of SME current accounts.[5]

In addition there is a worrying trend towards short termism in the bank lending market. While short termism may manifest itself in bank overdraft facilities repayable on demand (reducing the ability for businesses to plan and invest over a longer period with greater certainty and predictability of finance), a shift to term loans may result in more cautious lending decisions upfront, as loans are not repayable on demand, plus an increased requirement for collateral.

These long-standing problems have been exacerbated by the financial crisis and the return of recession. Access to credit declined markedly for SMEs in the UK during the financial crisis. The following table shows the decline in successful loan applications by SMEs between 2007 and 2010 in the UK and Germany (as a percentage of total loan applications):

	2007		2010	
	Successful	Unsuccessful	Successful	Unsuccessful
United Kingdom	88.4	5.6	64.6	20.8
Germany	85.3	6.7	75.9	8.2

Source: Eurostat News Release STAT/11/144 3 October 2011

[5] Independent Commission on Banking, Final Report Recommendations (September 2011) p 168.

As can be seen, the decline in Germany has been much less pronounced. If successful loan applications had continued at the same level in the UK as in Germany during the financial crisis, lending to small businesses could have been around 18 per cent higher.

In addition, banks are faced with the changes to capital requirements, known as Basel III, which will make them safer but virtually eliminate long-term lending.[6] Basel III applies a risk weighting system for assets and means an increased risk premium for lending to SMEs. The system creates the potential for a crowding-out effect on lending to SMEs and certainly points in the direction of greater residential property collateral requirements and lower loan amounts. The risk weighting also favours large enterprises with good external credit ratings over SMEs.

The Bank Lending Survey by the ECB in July 2011 found that banks in 2012 intend to build their capital position through retained earnings and divest themselves of riskier assets[7]. That has clear implications for the scale, pace and nature of lending to SMEs.

An added problem for SMEs is the lack of an alternative source of debt to that of traditional bank lending. Various reports have identified the fact that the preponderance of debt raised by companies is traditional bank debt with only a relatively small amount of debt raised via corporate bond issues.[8] Even within Europe the ratio of private sector bond market capitalisation to GDP is 0.16 in the UK compared to 0.34 in Germany and 0.6 in Italy (the ratio in the US being 1.2)[9] SMEs are thus dependent on traditional bank lending to meet external debt financing requirements with the difficulties that creates.[10]

There is also a gap in the provision of relatively modest amounts of equity to SMEs. Once again, as for debt, there is asymmetry of information between equity provider and the business on issues of viability and profitability. There are also high fixed transaction costs in relation to due diligence, relative to the size of investment. This results in a gap in the market where equity providers focus on a smaller number of larger investments, focused on lower-risk, established businesses with a solid track record.

The gap for first stage equity has been widening and is now perceived to be between £250,000 and at least £2 million (with some regarding it as high as £5 million). It is a structural gap remaining even in normal market conditions.[11] A review in 2009[12] also

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[6] Bank for International Settlements: Basel Committee on Banking Supervision – Basel III: A global regulatory framework for more resilient banks and banking systems.

[7] Financing SMEs and Entrepreneurs 2012: An OECD Scorecard pp 37 and 38.

[8] See Nigel Doughty: Fulfilling the Promise of British Enterprise p15; Tim Breedon: Boosting Finance Options for Business pp 19-24; TUC: Banking After Vickers, January 2012 p 5.

[9] TUC: Banking after Vickers p 5.

[10] EU Commission Staff Working Paper accompanying the document: An action plan to improve access to finance for SMEs (7 December 2011) p 2.

[11] Department for Business Innovation & Skills, The Supply of Equity Finance to SMEs: Revisiting the Finance Gap.

[12] The Provision of Growth Capital to UK Small and Medium sized Enterprises (23 November 2009).

identified a gap in the provision for growth capital for established viable SME businesses seeking to grow. This review concluded that, although exacerbated by the recession, the growth capital gap was a permanent one. There is a dearth of data relating to performance of growth capital investments which suppresses investor appetite and places upward pressure on the level of required return. The growth capital gap has been identified as existing between £2m (being the ceiling of existing Government interventions) and £10m (being the threshold for attracting private equity and venture capital funding).

Lessons at Home & Abroad

There are many international examples of government-backed intervention in this area. In fact, the UK is currently unique among the members of the G8 in not having a dedicated institution dealing with SME financing issues and initiatives. The bodies responsible in the other G8 countries are:

Canada	-	Business Development Bank of Canada
France	-	Caisse des Dépôts et Consignations (CDC)
Germany	-	Kreditanstalt für Wiederaufbau (KfW)
Italy	-	Cassa Depositi e Pretiti (CDP)
Japan	-	Japan Finance Corporation Small and Medium Enterprise Unit
Russia	-	Russian Bank for Small and Medium Enterprises Support
USA	-	Small Business Administration (SBA)

Developing economies are also using such structures. The Brazilian Development Bank (BNDES) has engaged in a process which it calls 'the democratisation of credit'.[13] This has focused on investment in machinery and equipment and in micro, small and medium sized companies (MSMEs). Disbursements to MSMEs and individuals were £6.9bn in 2008, £7.63bn in 2009 £14.58bn in 2010, an increase between 2009 and 2010 of 90%.[14]

We can also learn from past experience in the UK. After the Second World War the Industrial and Commercial Finance Corporation (ICFC) was created to address the small business funding gap. The company was set up by the Bank of England and the then 'big five' clearing banks. The banks were proposed as funders of ICFC by the Bank of England to meet criticism that they had neglected long-term investment in British industry.[15] It employed its own technical specialists as well as familiarity with

[13] BNDES Annual Report 2010 p 21.
[14] BNDES Annual Report 2010 p 24.
[15] Richard Coopey: The First Venture Capitalist: Financing Development in Britain After 1945, The case of ICFC/3i (Business and Economic History Vol 23 No. 1 (1994), p 264).

local businesses through a regional branch network. Its role was that of the locally-informed investor plugged into the business climate and the client.

To free itself from dependence on the clearing banks, ICFC moved to raising funds in the market. However that capital raising created pressure to produce greater returns on equity, which led to a shift away from longer term, less attractive returns which its core mission delivered, to shorter term, higher returns.[16] The economic slumps of 1974 and 1981 resulted in a dilution of its aims even further as it attempted to chase profitability by widening its investment remit.

The ICFC experience suggests the following key elements which need to be borne in mind when considering the nature of any Government intervention: first, the strength of a local network; second, technical expertise allowing informed investment decisions (addressing the asymmetry of information); and third, the tendency of private capital to drive investment behaviour towards shorter-term, higher returns.

The Business Development Bank of Canada, operates along similar lines. It has an SME lending operation which accounts for 2.9% of all term loan financing in Canada. Its activities are complementary to those of the existing market, plugging gaps as they exist or arise in the future. It has a higher risk appetite, running a credit loss rate five times higher than the market standard but it prices that risk. It operates via a network of 103 offices and estimates that its clients in 2011 contributed CAN$53bn to Canadian GDP. In excess of 6% of its clients are start-up businesses less than 2 years old. 63% of the start-up businesses it has financed survive more than 5 years, against 51% of all Canadian start-ups. 91% of its clients are SMEs with fewer than 50 employees.[17]

There are many other international examples listed above which offer insights into the role a British investment Bank could play. The role of these bodies ranges widely, and includes some which lend directly to businesses and others which provide guarantees or subsidised loans through commercial banks. Two different types of model are explored in more detail in this report – the German KfW and the US Small Business Association (SBA).

[16] David Merlin-Jones: The Industrial and Commercial Finance Corporation: Lessons from the past for the future (Civitas, October 2010).

[17] All data in this paragraph comes from the Business Development Bank of Canada Corporate Plan Summary 2012-2013 to 2016-2017 and its Annual Report 2011.

The German KfW

KfW is 80% owned by the Federal Republic of Germany and 20% by the individual German states. It has a two tier board structure. The supervisory board has Federal Government and State representatives (including Federal Ministers), representatives of the Sparkassen and other banks, industry representatives, members appointed by Parliament and trade union representatives.

It has no branch network and does not lend directly. It is a second tier bank providing commercial banks with liquidity loans at low rates and long maturities. It funds itself as to 90% of its borrowing needs through the capital markets, principally through bonds guaranteed by the Federal Government. That, together with being exempt from corporate tax and having no requirement to remunerate its shareholders for their equity, means KfW is able to provide loans at a lower rate than commercial banks. KfW does not compete with commercial banks, instead facilitating their business in those areas within its mandate. It provided financing of €17bn in 2008, €23.8bn in 2009 and €28.5bn in 2010.[18] Financing is generally granted on a medium to long-term basis.

In the area of business start-ups, the products it has available include:

- Loans for individuals and small enterprises to fund capital expenditure and working capital where the commercial bank only bears 20% of the credit risk. The loan term is up to 10 years at a fixed rate with repayment holidays in the early years before the business is generating profit
- Start-up capital loans with a loan term of up to 20 years with a fixed rate for up to 10 years and the option for repayment holidays in the early years
- Subordinated loans for a 15 year term with no repayment for the first 7 years and a subsidised interest rate for the first 10 years (with a deep subsidy in the first 3 years). This subordinated loan strengthens the business's equity base and allows the business to raise debt capital from commercial banks.
- Start-up coaching and a grant towards the fees of a management consultant.

These illustrate the types of financing a British Investment Bank could consider.

This long-term, structured funding from KfW, offers a predictable flow of finance to SMEs attuned to their needs. It is particularly noteworthy that KfW's lending increased in the years following the credit crunch, a counter-cyclical approach to lending which helped to sustain SME access to finance to a greater extent than was the case in the UK, something which is of vital importance given the key role which SMEs play in the economy. In the aftermath of the credit crunch, KfW launched a special programme to finance investment and equipment.

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[18] KfW Annual Report 2010.

The US Small Business Administration

In the United States, the SBA was created in 1953 with the primary purpose of encouraging lending to small businesses through government loan guarantees. The main product is the 7(a) loan programme, providing loans from $5,000 to $5.5m. It offers to guarantee a proportion of the loan. This proportion was increased to 90% by the Obama administration pursuant to the American Recovery and Reinvestment Act in 2009 as part of an economic stimulus to address the financial crisis created by the credit crunch. The SBA charges a guarantee fee which is priced to cover the cost of loan defaults so that the guarantee business should be revenue neutral (or even positive). As part of the economic stimulus programme, the guarantee fees were waived.

The SBA guarantee is designed to facilitate loans which would not otherwise have been made. The programme bears similarities to the Enterprise Finance Guarantee (EFG) programme in the UK, although the loan amounts, level of guarantee and tenor of loans differ. In addition, the scale of the EFG programme is enabling a fraction of the lending which the SBA programme is delivering.[19]

Such a state-backed guarantee programme has strengths and potential weaknesses:

- By providing a guarantee rather than lending, the state is able to leverage its contribution and minimise its actual liabilities
- Providing high levels of guarantee (75% plus) creates potential moral hazard as the lending institutions are insulated from risk and so may be tempted to include hopeless credit risks
- Creating a self-financing, revenue neutral guarantee business requires expertise within the guarantor
- The guarantee fee can be passed onto the borrower so does nothing to address the cost of debt for small businesses
- A system that relies on lenders to conduct credit checks and to disburse funds which are guaranteed to a high degree risks lax disbursement procedures[20]
- Guaranteeing the loan from lender to borrower does nothing to reduce the funding cost of the lender
- There is a risk that the guarantee does not create additional lending but rather acts as an extra layer of protection for the lender.

The SBA has also run the Small Business Investment Company (SBIC) programme since 1958. It aims to fill the funding gap that exists for businesses seeking patient capital of between $250,000 and £5m. Funds are advanced via SBICs, licensed by

[19] Nigel Doughty: Fulfilling the Promise of British Enterprise p 18.

[20] The Office of the Inspector General, Fiscal Year 2011 Report on the SBA found 27% of loans in the 7(a) programme had been improperly paid due to failure to administer loans in full compliance with SBA requirements and prudent lending practices.

the SBA. The SBIC raises its own capital ($5m) and this is then leveraged (typically 2 to 1, but increased in the 2009 economic stimulus to 3 to 1).

The investments are made by the private-sector-run SBICs with private equity professionals who have an incentive to make sound investments because they have 'skin in the game' as their own money is at risk first, ahead of the SBA guaranteed debt and also because the effect of the SBA leverage gives them the potential to realise significant profits. That addresses some of the moral hazard issues which the 7(a) loan guarantee programme creates. The SBIC debentures charge annual fees to the SBICs which are designed to finance the cost of the guarantee programme making it revenue neutral for government. Since its inception, the SBIC programme has helped finance thousands of small businesses including success stories such as Costco, AOL, Apple, HP and FedEx.

Small and medium sized enterprises play a crucial role in our economy, and yet there are well known and long-standing problems around their financing. These have been exacerbated by the financial crisis and return of recession. It is telling that the UK is the only member of the G8 without a dedicated institution dealing with SME financing issues and initiatives. These other institutions provide useful lessons and a range of models which could be considered for a British Investment Bank.

Part 2: Supporting Infrastructure Investment

There are over 500 infrastructure projects and programmes over the next decade which will need funding, with an aggregate value of £250bn. Of that it is estimated that two-thirds of the investment in the period to 2015 will be funded by the private sector (principally through utility bills and fares) with the remainder either partially or fully publicly funded.[21]

Separately from the source of funding is the method of financing to deliver the investment. Here there are various elements to be considered. The private finance market has been affected by the impending regulatory impact of Basel III for banks and Solvency II[22] for insurance companies, the effect of which will be to make infrastructure investment less attractive for them as an asset class as they will be required to hold a greater element of capital on their balance sheets to reflect the long-term nature of the investment.

This leads to a potential dichotomy of approach for government intervention. In the area of privately-funded infrastructure projects there may be areas where the risk of delivery is such that the market is unable, or unwilling, to finance the projects and where government intervention is necessary to facilitate the project. With publicly-funded projects the issues relate to the lack of certain types of private finance which have hitherto been available (notably long term commercial bank debt and monoline-wrapped[23] bond finance), the desire to attract pension funds and insurance companies to increase their investment in infrastructure projects (on the basis that they provide stable, long-term returns which are an attractive source of revenue to fund the long-term liabilities which those institutions have) and the overall cost of private finance when compared with financing the project publicly via gilts.

The challenge of meeting the need for infrastructure investment is massive and cuts to public sector investment and the unwillingness of the private sector to invest during the current stagnation mean that there is a significant risk that it will not be met.

Lessons at Home & Abroad

The Green Investment Bank offers lessons for a wider British Investment Bank. Green infrastructure investments of over £200 billion have been identified as

[21] HM Treasury, National Infrastructure Plan 2011, November 2011
[22] EU Directive 2009/138/EC.
[23] These bonds were backed by credit insurers to give the bonds an investment grade credit rating. See EIB: The Europe 2020 Project Bond Initiative – 27 April 2012.

necessary over the next 10 years.[24] Historic green investment has been at the rate of £6-8bn per year. The constraints on bank lending and lack of risk taking by institutional long-term investors is compounded in the area of green technology where projects can involve novel technologies and business models with little or no track record. In addition, the full benefits of technological innovation may not be reaped by the original business innovator, with follow-on businesses capturing value without the risk and upfront costs of the original innovation and development. This is a further drag on the willingness of financiers to invest.

The Green Investment Bank is designed to attract investment by acting as a pioneer financier, adopting a 'crowding in' approach. It should also develop or participate in new financing structures to group projects and sources of finance to help to overcome the high level of transaction costs resulting from due diligence of novel projects and technologies. By being a frontier investor in novel projects the Green Investment Bank should help to develop track records for projects and technologies, thus assisting in alleviating information asymmetries which in turn allows proper risk evaluation and a reduction in risk aversion.

As previously indicated, the scale of investment is large and a multiple of historic levels of investment. There is therefore an urgent need to stimulate investment. However the Green Investment Bank will not be able to borrow to invest before 2015 and then only if public sector net debt (PSND) is falling as a percentage of GDP. Therefore, the initial funding will be £3bn and its impact and effectiveness will be constrained. It will be investing a limited sum where returns available for reinvestment will not materialise for several years.

The Green Investment Bank has a set of explicit purposes for which it can invest. Its activities are likely to have synergies with other areas of infrastructure intervention as well as with interventions to address gaps in SME financing by a British Investment Bank. For example, a British Investment Bank could have potential role in accelerating investment in housing. The National Infrastructure Plan 2011 does not cover housing, but housing infrastructure is important in facilitating economic growth by allowing flexibility and mobility in the labour market. The KfW offers a model which could be considered here, with its green activities separately identifiable within the overall range of KfW activities and interventions, but complement those activities.

At an EU level, the European Investment Bank has been promoting and developing a 'Project Bonds Initiative'. The objectives of this are to stimulate investment in infrastructure by attracting institutional investors to finance projects which have stable and predictable cash flow generation characteristics by providing credit enhancement to capital market bonds issued to finance a specific project. The

[24] UK Green Investment Bank: Impact Assessment No BIS0342, 15 May 2012.

intention is to stimulate bond financing as an alternative source of financing for projects in addition to commercial bank loans. The initiative is aimed at large-scale infrastructure projects in the target areas of transport, energy and broadband.

The Project Bond Initiative does not address the issue of the cost of private sector debt compared to public sector capital. The challenges for financing infrastructure are long-term and structural. The effects of both Basel III and Solvency II are to increase the level of capital charges. The EU/EIB initiative, if established as a fully-fledged scheme, will have EU-wide application and while that will extend to the UK, the overall funding available will be finite.

There are also other initiatives at an EU level, notably the European Fund for Energy, Climate Change and Infrastructure (the "Marguerite Fund"). The core sponsors are various public development banks of EU member states. The Fund has raised €710m (of a targeted €1.5bn) predominantly from its core sponsors. The areas of investment are Transport (30% - 40%), Energy (25% - 35%) and Renewables (35% - 45%), with 35% of the Fund invested in brownfield schemes for replacement, modernisation and capacity enhancement of existing assets and 65% in new projects and facilities. The investments are to be exclusively in the 27 EU Member States with no more than 20% of the Fund invested in one Member State. The minimum investment is €10m and the maximum is 10% of the overall Fund size. The OECD estimates that the multiplier and support effects for private funds will allow the €1.5bn Marguerite Fund to mobilise investment of about €30-50bn.[25] The Fund will not be a passive equity investor but will have an active involvement throughout the life of the project.[26] Part of the rationale of the Marguerite Fund is to serve as a model for establishing similar funds combining market-based principles with public policy objectives.

From a UK perspective the quantum of local investment requirements, as identified in The National Infrastructure Plan 2011, combined with the constrained future availability of finance points to a role for government intervention in addition to the EU initiatives outlined above. The establishment of the Green Investment Bank is providing a model which could be developed and learnt from. A British Investment Bank which invested in infrastructure would also need to have a financing structure which provided the steady funding stream which would attract long-term investors. But if the Green Investment Bank is successful in 'crowding in' investment from the private sector by proving technologies and providing reassurance to other investors about the viability of individual projects then it is a model which should be considered for other sectors.

[25] Financial Stability, Fiscal Consolidation and Long-Term Investment after the Crisis: Franco Bassanini and Edoardo Reviglio, OECD Journal: Financial Market Trends Volume 2011 Issue 1 pp31-75.

[26] Marguerite Fund website: Fund Overview.

Part 3: Practical Issues to Consider

A British Investment Bank would need a wide measure of independence from government to meet the needs identified above. In almost all the countries reviewed, the institution which is the focus of government interventions has been established by or exists or operates by virtue of an act of parliament or equivalent, including KFW in German, CDC in France, CDP in Italy, the SBA in the US and the Business Development Bank of Canada.

Given the strategic nature which a British Investment Bank would have, the broad range of interested parties affected by its activities, and its dual bottom line business strategy combining a private sector, commercially-focused, management and operation with a distinct public policy mission, one possible route would be to establish an Advisory Council which would not have executive authority over the Bank but which would meet with the board to review the effectiveness of its dual bottom line strategy. Members of the Advisory Council could include representatives of key government departments, trades unions, representatives from business, and others. There is a precedent for such an oversight structure: an Advisory Council was established as part of the governance arrangements for Partnerships UK when it was set up by the Labour Government in 2000.

Whichever structure is adopted there should be a clear distinction between oversight of mission and purpose, and day-to-day operational control.

In the same manner as it is envisaged that the Green Investment Bank will be allowed to borrow, so a wider British Investment Bank could have similar powers. The extent of those powers would need to be considered. For example, under the terms of the Business Development Bank of Canada Act, the Bank is permitted to borrow provided it does not have debt in excess of twelve times the equity of the Bank.[27]

As far as the precise nature of any borrowings is concerned, the institutions reviewed raise funds in the market with their debt obligations in some cases supported by an explicit government guarantee (eg KfW in Germany) an implicit government guarantee (e.g CDC in France) or with no government guarantee at all, whether explicit or implicit (e.g CDP in Italy).

Other sources of funding could also be considered. One which has international precedents would be to channel funds raised by National Savings and Investments (NS&I) into the institution as an additional source of financing. This would be similar to the role which CDC in France performs in relation to funds deposited by individuals in tax-exempt savings schemes such as Livret A. CDC uses the funds to grant long-term loans to fund public interest projects in areas such as social housing and urban

[27] Business Development Bank of Canada Act, section 30.

renewal. CDP in Italy (which is 70% owned and controlled by the Italian government) is funded via postal savings from individuals. CDP issues savings products which are marketed by Poste Italiane, the Italian postal service. The products are guaranteed by the Italian state.

Using NS&I as a source of funding would have several attractions:

- it creates an effective depositor base for a British Investment Bank
- as a source of funding NS&I products are a more efficient means of Government raising funds than through gilts issues[28]
- NS&I could be used to develop and market products such as Green ISAs which could be used to fund the activities of the Green Investment Bank.

This latter idea of developing and marketing specific products could be widened to address areas such as social housing. The tax free nature of certain of the NS&I products makes them particularly attractive to higher-rate taxpayers. NS&I could also be the channel through which further products could be developed including growth bonds for infrastructure development.[29] In India, IDFC recently launched a second tranche of infrastructure bonds, which are intended to be listed and which entitle subscribers to set their investment in the bonds against their taxable income (subject to a cap).

The activities of a British Investment Bank and the involvement of the Government as an investor in/funder of the Bank give rise to issues relating to compliance with EU State aid rules which need to be considered. This includes both public interest activities and commercial activities. The Government is currently seeking State aid approval for the activities of the Green Investment Bank and the outcome of that will undoubtedly inform the analysis of the State aid consequences of the activities of a wider British Investment Bank in addition to the European Commission's approach to dealing with KfW in Germany and CDC in France.

[28] In the NS&I Annual Report and Accounts and Product Accounts 2010-11 (p 9) the NS&I products were £0.8bn more cost effective than raising the same amount via issuing gilts.

[29] Financial Times 6 June 2012: Idea of growth bonds floated to fund housing by Jim Pickard and Hannah Kuchler.

Conclusions

The key principle for any British Investment Bank is that it must operate in a commercial manner to ensure that investments and interventions are made on a rational basis, only to support viable businesses with a proper analysis and pricing of risk. All lending should be in addition to, or in partnership with, private lending. This is important where the intervention is designed to fill a gap which the market is not providing.

There is a strong case for a British Investment Bank along these lines. These are long-standing and concerning weaknesses both in small business financing and infrastructure investment in the UK. Fortunately, as I have set out, there are many international examples from which we can learn in both areas. Even here in the UK we can draw on the experience of the Industrial and Commercial Finance Corporation set up after the Second World War, and the creation of the Green Investment Bank.

In developing Labour's active industrial strategy, and in particular in considering the potential role of a British Investment Bank, this strong evidence and rich seam of experience should not be ignored.

Labour's Policy Review

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