OFFICIAL REPORT
AITHISG OIFIGEIL

Economy, Energy and Fair Work Committee

Tuesday 28 May 2019

The Scottish Parliament
Pàrlamaid na h-Alba

Session 5

Tuesday 28 May 2019

CONTENTS

ECONOMY, ENERGY AND FAIR WORK COMMITTEE
18th Meeting 2019, Session 5

CONVENER

*Gordon Lindhurst (Lothian) (Con)

DEPUTY CONVENER

*John Mason (Glasgow Shettleston) (SNP)

COMMITTEE MEMBERS

*Jackie Baillie (Dumbarton) (Lab)
*Colin Beattie (Midlothian North and Musselburgh) (SNP)
*Angela Constance (Almond Valley) (SNP)
*Jamie Halcro Johnston (Highlands and Islands) (Con)
*Dean Lockhart (Mid Scotland and Fife) (Con)
*Gordon MacDonald (Edinburgh Pentlands) (SNP)
*Andy Wightman (Lothian) (Green)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Andrew Castell (Par Equity)
David Grahame (LINC Scotland)
Jock Millican (Equity Gap)
David Ovens (Archangel Investors)
Graeme Sands (Clydesdale Bank)

CLERK TO THE COMMITTEE

Alison Walker

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Economy, Energy and Fair Work Committee

Tuesday 28 May 2019

[The Convener opened the meeting at 10:00]

Decision on Taking Business in Private

The Convener (Gordon Lindhurst): Good morning, and welcome to the Economy, Energy and Fair Work Committee's 18th meeting in 2019. I ask everyone in the gallery to turn their electronic devices to silent mode, if they have not done so already.

Agenda item 1 is to ask the committee to decide whether to take in private items 3, 4 and 5. Do members agree to do so?

Members *indicated agreement.*

Scottish National Investment Bank Bill: Stage 1

10:01

The Convener: Item 2 is stage 1 of the Scottish National Investment Bank Bill. We have with us five witnesses. Graeme Sands is business banking, corporate and mid-market director at Clydesdale Bank; Andrew Castell is a partner in Par Equity; Jock Millican is investment director at Equity Gap; David Ovens is chief operating officer at Archangel Investors; and David Grahame is chief executive of LINC Scotland. I welcome all five of you.

I will start with a question about supply of capital. It has been suggested in evidence to the committee that the supply of capital in Scotland is increasing, with more funds being available from the private sector. However, there seems to be a lack of demand in the market. Does the panel agree with that? If so, what are the reasons for it? How will the Scottish national investment bank be able to overcome the lack of demand for capital in the Scottish market?

Graeme Sands (Clydesdale Bank): Good morning, convener and the committee.

Rather than give the committee an anecdote, I will outline some statistics. I recently looked at the "SME Finance Monitor: Q4 2018" report, by the French consulting group BVA BRDC. It looks at statistics for SME borrowing across the whole United Kingdom; there is no reason to think that the outcomes in Scotland would be any different. The report's conclusions are interesting. Of every 10 applications for finance from small and medium-sized enterprises, seven received precisely what they asked for. One out of 10 took a facility that was not exactly what it had asked for, and two did not get a facility or—as with a small proportion—declined to take the facility that they were offered. In answer to your question about whether there is a lack of supply or of demand, those statistics indicate that there is a little bit of a lack of demand.

On the second part of your question about what is driving the lack of demand, there are many different views. Clydesdale Bank has landed on the view that the nature of the economy is changing. There is an old-fashioned notion that people come forward for finance for things like plant and equipment, or because they are going to put in place a new production line from which they will make a profit. However, as Scotland's economy in particular gravitates toward services, it is not clear that businesses necessarily have as much demand for finance as they used to have. It is certainly becoming clear that they have a different type of demand from what businesses had 20 or 30 years ago.

Those are my bank's answers to the two questions that you posed, which are very useful questions in the context of the bill.

David Ovens (Archangel Investors): I will give a different perspective: I will challenge the premise that there is a lack of demand. I do not think that there is a lack of demand in Scotland—the problem is rather that there is a lack of joined-up supply. Demand is most overt in the market in which Archangel operates, which is businesses that are at the very early stages. That demand emanates from a number of sources—from competitions such as the converge challenge to the great research and development that is coming out of our universities.

Funding and financing in that market is challenging, because it requires great patience to take a business from initial financing through to the point at which it can access alternative forms of conventional finance. Typically, Archangel would invest at a very early stage in a company's development, but will assume that we will be the lead investor throughout its journey, which might last in excess of 10 years. That journey will take the company to the point at which it can access other forms of capital—perhaps the type of capital that Graeme Sands and his colleagues would be able to provide. The challenge is to address specific market failures along the journey, and to ensure that the SNIB comes in as an institution that will address those market failures.

The Convener: Can you clarify your view on what Graeme Sands said? As I understood it, he said that there is more demand for services, or a drive towards creation of service businesses rather than manufacturing businesses that—for want of a better phrase—create actual things?

David Ovens: The bulk of the companies in the technology sector in which we invest manufacture things—they are product rather than service companies. As I articulated, the challenge is that not enough of those companies make the journey from the earliest stage to more conventional capital demand. We need to address that issue in the market. There is demand for companies that make things and produce innovative technology, but there is currently inability to take those companies from the very early stage, through commercial maturity, to the point at which alternative supply sources are available.

The Convener: I will let Graeme Sands back in briefly, and then bring in David Grahame.

Graeme Sands: I will clarify my earlier comment. In talking about the change in capital requirement, I was referring to a move away from heavy manufacturing and plant equipment. In many cases, the businesses need research and development capital. Ultimately, they make things, but the pathway towards that type of manufacturing is very different to what we might have expected to see 30 or 40 years ago.

David Grahame (LINC Scotland): We are talking about a really important and complex area. We need first to distinguish between "need" and "demand". Need is huge, but the ability to convert that need to fundable demand is a big issue, so we need to unlock that if we are going to release economic potential.

Demand can be inhibited by a number of factors. The most basic issue is lack of awareness of what is available and how to go for it. However, confidence can also be a factor, as businesses tend to come and go depending on how uncertain the times are.

In addition, at any point in the cycle the nature of demand can be out of step with available supply. An important requirement of SNIB is that it be well informed and agile in order to enable it to respond. It will also need to be extremely well integrated with all sorts of other agencies in order to manage the demand flow properly.

LINC is currently a major originator source for the Scottish Investment Bank. Over the past three years, our network has taken 255 deals worth £167 million to the SIB. That involved the SIB putting in £44 million while we put in £123 million; leverage and co-investment are very important. However, we know that we are not funding anything like everything that is coming forward.

The Convener: I will bring in Dean Lockhart, while we are on the subject of demand.

Dean Lockhart (Mid Scotland and Fife) (Con): I have a follow-up question about demand. We have heard from the SNIB itself that it will not originate funding opportunities—it will rely on other entities such as Scottish Enterprise and LINC Scotland to do that, rather than going out and finding businesses to fund. Given the significant additional capital that will be available, do the existing enterprise entities have sufficient resources to deal with such a step up in the amount of available funding? Are they set up to meet that demand?

Jock Millican (Equity Gap): It is important to be clear about how they will bring businesses forward and whether, from our perspective, those are investable businesses. We would want to see that they are investable rather than just viable; there is quite a difference between the two.

We currently work closely with the Scottish Investment Bank's Scottish co-investment fund, which works extremely well. We meet most of the demand from investable companies, although some companies are, at that stage, viable but not investable. That is perhaps where some of the funding needs to be looked at separately.

Andrew Castell (Par Equity): I have two points to make. First, I emphasise the distinction that Jock Millican just made. The committee might benefit from remembering that there is a whole universe of businesses, a relatively small proportion of which are the kind that interest me and my colleagues in equity investment—the very high growth potential, but risky businesses that have the potential to deliver high returns, but also to generate losses.

Within the universe of bankable businesses there is another group: the businesses that can sensibly be lent money, which are more interesting to my banking colleague, Graeme Sands. A large number of them are perfectly viable and sensible, but they will be neither bankable nor of interest in the eyes of venture capitalists.

We talk about whether there is an imbalance in the demand for and supply of capital. There will be potential mismatches: certain types of company are crying out for capital and cannot get it, while other types of company do not really need capital but are being offered it. While there might, in the round, be equilibrium and some demand for capital, there will be isolated pockets of mismatches where there are supply and demand issues.

My second point is on the sufficiency or otherwise of what looks like quite a big number: £2 billion over 10 years. I will outline how we currently work with the Scottish Investment Bank. Par Equity drags a lot of money from south of the border—we are probably an outlier, to a greater or lesser degree, in respect of the proportion of money that we invest that comes from down south—and we put a disproportionate amount of such money to work in Scottish companies. The co-investment money that we get from the Scottish Investment Bank is extremely useful in enabling us to drag that investment capital into Scotland, and to be persistent and patient with the companies in which we invest. One of our key objectives or aspirations for the Scottish national investment bank is that that successful model should not be broken in the transition.

David Ovens: Was Dean Lockhart's question about the sufficiency of resource related to the personnel, or the capital that has been applied to the new institution?

Dean Lockhart: It was a bit of both. In addition, is it right to have a model that divides origination and lending, with a number of different entities looking at different parts of the supply chain?

David Ovens: On sufficiency of capital resources, the proposal is to capitalise the bank at £2 billion over a period, which is broadly in line with other national promotional banks. On the face of it, that seems to be a sensible level of capitalisation that could go quite a long way if it is applied sensibly to address market failures.

On allocation of resource within the organisation, the Scottish Investment Bank currently works largely on an accredited-partner basis—in a sense, it will back the private sector. There will be a headcount required to manage the portfolio, but a lot of the heavy work will be done by the private partners—such as Archangel—that the bank is backing.

David Grahame: I have a similar comment to make. There is an opportunity to build on the partnership model and to find delivery efficiencies through not building an ever-bigger establishment. That might involve a lot of things that are outwith our space—for example, tapping into peer-to-peer lending as a delivery channel.

Dean Lockhart: Co-investment has been mentioned quite a lot. To what extent should the SNIB follow the co-investment model in leveraging public sector money with private sector money? To what extent should opportunities be identified by the private sector rather than by the bank itself?

David Ovens: If we look at what has happened with the Scottish co-investment fund over the past 15 years, we can see that it is a demonstrably successful model. There will be aspirations arising from the SNIB consultation, but you should not change a model that has been very successful over the past 15 years. You need to build on that model, which very much leverages and crowds in private sector investors. It has been copied around the world, most recently by the British Business Bank. The co-investment model has been very successful, and SNIB should build on that template.

10:15

Gordon MacDonald (Edinburgh Pentlands) (SNP): The British Business Bank has four objectives, including to increase the supply of finance and to create a more diverse finance market. What impact has the bank had in Scotland?

Jock Millican: The impact of the British Business Bank has been fairly limited, so far. It has had some involvement in Scotland, and it is increasing its presence here, along with the amount of opportunities that we are able to look at with it. It now understands the Scottish infrastructure model better and is able to work better with us on that front. However, we have still to do a lot more with it.

David Ovens: The British Business Bank is focused more on investing in funds than on core investment capital. As I alluded to a couple of minutes ago, the British Business Investments regional angel programme, for example, which is now competing almost directly in Scotland with the Scottish co-investment fund, is a replica of that fund model, in which co-investment capital is provided alongside funding from the private sector partner.

Graeme Sands: It is useful to remember that, historically, the Scottish co-investment fund has addressed only the equity side of funding. To a degree, that is also true of the British Business Bank's initial expansion. We should not forget that the British Business Bank also provides the enterprise finance guarantee scheme, which is a tremendously substantial way of crowding in—if we want to use that phrase—debt funding into businesses and ensuring that they get greater access to bank capital.

As we begin to think about how the Scottish national investment bank is established, it is important—certainly from my perspective—to ensure that we think about equity and debt. For example, does the mechanism of something like the Scottish co-investment fund work equally well for debt in the future? It might well do, or we might consider that something like the British Business Bank already substantially addresses that aspect.

Gordon MacDonald: The British Business Bank's "Annual Report and Accounts 2018" highlights its regional funds in the north of England, the midlands, Cornwall and the Isles of Scilly, and states that they

"are now delivering critically-important debt and equity finance to boost their respective regional economies."

Is there any particular reason why it has not focused so much on Scotland?

Andrew Castell: I say, based on a conversation that I had with someone from British Business Investments last week, that that is a back-handed compliment. The bank is, essentially, focusing on regions where it sees a real need for its intervention: it does not see Scotland as being in that category because of the success of what has been happening with SIB and Scottish Enterprise.

Colin Beattie (Midlothian North and Musselburgh) (SNP): The target rate of return for SNIB will be established before it is actually vested. What level of target rate of return would you expect a bank with the characteristics of SNIB to achieve?

We have heard that SNIB will potentially lend to not-for-profit companies and all sorts of different aspects of the third sector, which adds complexity to its position. How would you establish what a reasonable rate of return would be?

Andrew Castell: Much of that will depend on what the portfolio of assets looks like. When the bank is up and running, it will want to achieve a certain mix of lending, equity investment and so on, which will drive its idea of what a reasonable rate of return should be.

Colin Beattie: I take on board what you say: until there is a portfolio, we do not really know.

Andrew Castell: Exactly.

Colin Beattie: Nevertheless, the bank will put in place a target before it is actually vested. In your view, what would be a reasonable target and why?

Andrew Castell: As an accountant, I can tell you about the cost of most things but the value of very little. Much will depend on the missions that are set for the bank, and the non-financial targets around some of the broader social goals that those missions are intended to deliver.

In absolute financial terms, one can look at what might be a reasonable market return on venture capital or on credit activities and come up with a number. The big and very difficult challenge will be to throw into the mix some non-financial returns, which will be necessary in order to deliver on even a relatively small proportion of the great hope and excitement that the project has engendered.

Graeme Sands: First and foremost, Clydesdale and Yorkshire Bank is strongly in favour, in principle, of a Scottish national investment bank. Nonetheless, I point out that, although the "Consultation on the Scottish National Investment Bank Bill" uses words such as "bold" and "ambitious" and states that the bank is designed to address third-sector and other wider socioeconomic concerns—on page 7, it suggests that the bank must look at different types of financing—it also states that the bank must be "commercial". That is in addition to achieving an ambitious rate of return. It will be incredibly hard for the bank to achieve all those aims in combination if, as we would suggest, its remit keeps it clearly away from existing commercial opportunities.

We are asking SNIB to go to places that the commercial market does not currently go, presumably because of risk or for reasons of patience and long-term capital. However, we are also asking it, as part of a very broad remit, to improve Scotland's economy. I wonder whether it is necessarily wise to establish an aggressive rate of return, or to establish a rate of return at all, ahead of the establishment of the bank's missions.

Jock Millican: A key term in the bill is "patient capital", and that is where the focus needs to be. The bank will be about providing long-term capital—there will be returns from some elements of that, but not from all of it. It would hamstring the bank very badly to set out an ambitious rate of return at an early stage.

Colin Beattie: Did the British Business Bank not set a rate of return of 2.5 per cent, which it has exceeded? It must have had a basis on which to set that target.

David Ovens: For all the reasons that my colleagues have outlined, a positive internal rate of return over a period of a time would be a successful outcome for the bank. In addition, we should not lose sight of the fact that the bank is being set up as an institution that will be a cornerstone of the economic foundations for the nation. Financial return is one measure of success, but the economic impact should be equally important in that regard.

Colin Beattie: The message that I am getting is that the target rate of return should not be too ambitious in the first place. I see that you are all nodding.

Graeme Sands touched on the issue of additionality and the need for SNIB to avoid competing with existing products on the market. Is that achievable, given the mission that SNIB will have? Is it achievable for SNIB to avoid competing with the multitude of financial sources that currently exist in the market?

David Ovens: Yes, and that should be SNIB's defining mission. To go back to the core objectives of SNIB, the driving mission is to create an institution that will drive economic performance in Scotland. It will do that on the one hand by supporting SMEs through market failure, and on the other hand by driving economic imperatives and missions that are set from time to time by ministers.

I will look at the market failure aspect first. The early-stage equity investment market in which we operate is very much an area of market failure. We are incentivised to invest in that area through various tax breaks from the UK Government, such as the enterprise investment scheme. However, that incentive would not in itself be enough to drive sufficient capital into that area of market failure, and the activities of the Scottish co-investment fund are therefore vital in leveraging our activities in that respect. That fund is additional to private capital—it is bringing in private capital rather than competing with it.

Secondly, I turn to the missions for SNIB. One of its missions, as the implementation plan articulates, concerns the transition to a low-carbon economy; it sets targets on petrol and diesel to be achieved by 2032, which is 13 years off. It would be very difficult to persuade conventional private capital to take a 13-year view on a return, but it is sensible for SNIB to intervene in that area. It is additional in that sense—it is not going to leverage out private capital.

Colin Beattie: Do you envisage that, rather than pursuing entirely different products, SNIB may have a role in supporting some of the existing capital investment into the country?

David Ovens: Where SNIB can crowd or leverage in private capital, that will be vital to its role. What it should not be doing is competing with conventional sources of capital from Graeme Sands and his colleagues at the Clydesdale Bank.

Colin Beattie: It is easy to say that SNIB should not compete with existing products on the market. What kind of products should it go for?

David Ovens: The area in which we operate is very equity driven. We might think about the funding journey for a company: for the first 10 or 15 years of its life, the relevant asset class will, 90 per cent of the time, be equity—that is the instrument that addresses the early market failure. As the company develops, other forms of financing may become relevant. However, with regard to the long-term patient capital that is really the driving mission of SNIB, equity or quasi-equity will be the relevant asset class 90 per cent of the time.

Graeme Sands: Another way to think about it is not just to look at particular financing products but to consider a company's life cycle and what it needs during different events in that cycle. One important point—I cannot recall if it is referenced in the consultation paper, but it has certainly been referenced in subsequent discussions—is the transition from early-stage equity to later-stage equity and then to debt finance. Those transition points are often quite hard, for a wide variety of reasons that I probably do not have time to go into here. That is an event in a company's life cycle that it may need support with. It is not about different commercial products per se, but the fact that those products are not necessarily available during those events.

More widely, I think that no one would suggest that, even in relatively efficient capital markets, there are not gaps in certain areas from time to time. The Clydesdale and Yorkshire Bank would simply suggest that the missions that are set out for SNIB should clearly identify what those gaps are, and clear evidence should be provided rather than relying on anecdote. We would be happy to work with SNIB in the future to help it to set out and explore those gaps.

Colin Beattie: Does anyone else on the panel have a view on that?

David Grahame: That has pretty much covered it. There are a lot of gaps—the staircase of finance is not complete. There are certainly issues beyond our level before companies get to conventional funding, and SNIB could provide leadership in that area. By getting that right, the bank would also lever in new finance, quite a lot of it from outside Scotland.

John Mason (Glasgow Shettleston) (SNP): We have talked about the commercial focus that the bank has to have, but we have also heard about the desire for socioeconomic and environmental returns. Does the public limited company model fit in with that? It is proposed that SNIB should be a plc. The Government looked at other models—Scottish Enterprise is a statutory body, for example, so its missions are set in statute rather than being left to the articles of association and so on. Are you comfortable with the plc model? Can it work?

10:30

Andrew Castell: I think that it can. On whether SNIB needs to be a plc or simply a private limited company, I point out that people typically go for plc status if they are contemplating raising capital externally. As I understand it, however, the plan for the immediate future is that the bank should be exclusively financed by the Scottish Government.

Essentially, SNIB is an example of that great Scottish invention, the investment trust—it is not really a bank. For that purpose, a plc works well enough. It also provides a degree of flexibility. The point about corporate structuring is that, if you do not like it, you can change it subsequently. Nothing is really set in stone for the institution by the fact that it is starting off as a plc.

John Mason: Do you think that, in some people's thinking, the very term "plc" suggests that there will be a big emphasis on commercial return, with less emphasis on the social and environmental aspects?

Andrew Castell: If only it were that reliable. There are plenty of plcs that we can think of—even banks—that have not done much by way of returning profits.

John Mason: True.

Jock Millican: The plc model covers the requirements quite well, and I do not think that there is any need for anything different.

John Mason: On the question of return, we have talked about risk and exactly where the bank fits in. The proposal is that it should be breaking even by 2023-24. Is that realistic, given what we have said about risk?

Andrew Castell: Earlier, I whipped out a calculator and considered that point. If we are thinking about it in government cash-accounting terms, I would say that there is not a hope. However, if we examine it at a company level and ask whether the SNIB would be able to turn a profit—in particular, an accounting profit—I would say that it probably would. Much will depend on whether the existing portfolio of Scottish Enterprise investments is transferred over to the bank, because that will, in principle, provide a number of exits and a portfolio whose valuation will, hopefully, continue to tick up. In cash terms, however, absent a strong weighting towards cash-generative assets such as loans, I do not see the bank breaking even.

John Mason: Let me clarify that, because some of it was a little bit technical. You are saying that, by 2023-24, the value of investments might be going up but we would not be able to get the cash out.

Andrew Castell: Yes, precisely.

John Mason: That could be a problem for the public purse, but the process would be understood.

Andrew Castell: Yes.

Jock Millican: I would agree with that.

David Ovens: From an investment perspective, it is difficult to see how the bank will be washing its own face within five years. However, I presume that the bank will have ancillary revenues as a function of facilitating investments, so there will be arrangement fees and perhaps portfolio monitoring fees, which will provide the bank with a recurring revenue source. It will not rely just on investment returns.

John Mason: You have all used the word "patient". You are not politicians, but politicians are not always very patient. Do you anticipate that, if the bank does not do terribly well for the first two or three years, people will be jumping up and down, wanting the whole system changed? I presume that part of the idea is—as you have suggested yourselves—that we will put money in and see the success of that perhaps 10 years later. Are you optimistic that that can and will happen?

David Grahame: Optimistic politically? The average time to a positive exit for the gentlemen here is nine years, but the whole cycle can easily take 15 years. It is 15 years since the co-investment fund was founded, and it is only now beginning to go where it should be going. It is essential that the institution takes that sort of profile. It is a real challenge for the people who are designing it to make it able to survive through political change.

John Mason: You say that the average exit time is nine years, but some businesses take off amazingly fast, whereas some do not.

David Grahame: Yes. Most of the bad news comes earlier, which is sometimes difficult politically. Things might all go in one direction for three or four years. The lemons ripen before the plums.

John Mason: That is a good quote.

Graeme Sands: That is why the gentle counsel that we are able to give here is on de-emphasising from aggressive rates of return. If you believe, as we do, that the Scottish national investment bank offers something positive for the Scottish economy, de-emphasising away from commerciality and aggressive rates of return is perhaps a way to make the SNIB politically sustainable in the more difficult period of its establishment, which is likely to be the first five years of its existence.

David Grahame: There is a useful piece of background information that you might want to draw on. Archangels did a very long-term study of the economic impact of its investment, which also considered the returns that it made. That study is worth looking at, because it assesses the economic impact in Scotland of a 20-year cycle of investing.

David Ovens: Archangels was established as an investment firm in 1992, and we got the University of Strathclyde to undertake that study in 2015, so it effectively took a 20 to 25-year view of what we had done. That goes back to the point that we have to be patient when it comes to the financial return. For us, a successful financial return comes within about 10 years.

Returning to what the SNIB is all about, we were generating an economic impact along the way without necessarily generating a financial return for ourselves. The output of the University of Strathclyde report was that, for every £1 of investment from Archangels, we were able to generate around £9.50 of gross value added to the Scottish economy. Over that period, we generated around £1.2 billion of economic value added to the Scottish economy through the investing activities of Archangels; our portfolio companies created 4,000 jobs; and every £1 that we invested created £14 of turnover. A lot of the economic activity that has been generated by what we do goes beyond the financial returns that we are hoping to generate in due course.

John Mason: That kind of creates a problem in relation to the whole GVA thing. Basically, everybody who comes to the committee claims that, for every £1 we invest in them, we will get £7, £8, £9 or however much back. Are you convinced that we can measure that kind of figure fairly, reliably and solidly? The return that your business or any business gets can be measured very exactly.

David Ovens: GVA is a recognisable methodology. Companies create jobs and generate turnover and profits. The GVA methodology is subjected to tweaks and subjective views, but it is fairly standard, recognisable methodology that provides at least a baseline of the impact.

Jackie Baillie (Dumbarton) (Lab): I wish to touch on the vision and objects that are contained in the bill. Some of the witnesses from whom we heard previously suggested that both the main and the ancillary objects do not quite capture the Scottish Government's vision, which was set out in the implementation plan—nor, indeed, do they capture the expectation that the bank will serve environmental and socioeconomic purposes. Are you satisfied with the objects, or do you think that they may be slightly vague as they stand?

David Ovens: I think that the objects in the bill reflect the fact that, constitutionally, the SNIB is going to be an enduring institution that will drive economic activity in Scotland. There are also various ancillary objects. The missions that go on behind it are going to change over time, and the institution will be subject to whatever Administration is in power and to whatever the macroeconomic position is at the time. It is not necessarily right to enshrine specific missions within the constitutional objectives of what the SNIB is trying to do.

David Grahame: The objects are generally satisfactory if they are taken in conjunction with the ancillary objects, which add a bit more clarification. From what I have seen previously, there will need to be a fuller understanding of what is meant by "commercial". We certainly do not think that that means just private enterprise.

Jackie Baillie: So, clarification is needed to expand the point that social enterprises and the third sector could be included. You think that that would be helpful in this context.

David Grahame: Yes, provided that the things that are being financed are capable, ultimately, of providing a return on the finance; otherwise, it is just a grant.

The SNIB is very important, but it will be only one public policy instrument for achieving socioeconomic objectives. For it to be effective, it is important to allow it to make that contribution in such a way that it is a good fit for an investment entity. It is one of the few channels for delivering public expenditure that is envisaged as a two-way street financially. That desire for sustainability needs to be borne in mind. The SNIB has attracted a huge amount of interest, ideas and expectations, but those could dissipate if there is a temptation to edge into things that should properly be tackled through departmental spending.

Jackie Baillie: Most social enterprises that I know of generate profits; it is what they do with their profits that is different.

David Grahame: Yes.

Jackie Baillie: There would be a rate of return for any institution.

David Grahame: Absolutely. As a phrase, "non-profit" is fine if it means an institution not distributing profit.

Jackie Baillie: Indeed.

David Grahame: However, it needs to be able to sustain itself.

Jackie Baillie: Absolutely. Do any other members of the panel have a view on that?

Andrew Castell: My view is that the implementation bill that we have before us will lead to the drawing up of the articles of the company of the SNIB, which I think should be fairly general. There is a process around the setting of missions for the bank, which Scottish ministers will come up with and which will be subjected to the scrutiny of the Scottish Parliament, as I understand it. That process will drive the granular detail of what the institution gets up to.

As I have to spend a certain amount of my time guddling around in bits of legislation, my pet hate is legislation that contains highly subjective, undefined terms. One of the particular dangers of trying to cater to the rapidly evolving third sector, not-for-profit organisations and social enterprise is that it is work in progress. There is a lot of jargon involved, and it is inevitably changing over time.

The fundamental point is that, as David Grahame observed, there is a lot of commercial activity among social enterprises and within the third sector, but it is clear, from the preceding evidence sessions, that a number of people have struggled with the objective of investing in commercial opportunities. We could do with some clarification that those are really just anything that is non-state.

Jackie Baillie: You must be older than you look, because the jargon, as you describe it, has been around—at least to my memory—for 20 to 30 years and has not changed much. So, there is clearly something going on there. The approach that you favour involves adopting a model that is sufficiently flexible and that allows ministers to specify missions.

Graeme Sands: To build on Andrew Castell's point, I suggest that the missions need to be set out very clearly. There needs to be very strong governance around those—tight governance that sets out what the mission is, what the market failure is and what the evidence for that market failure is.

Human nature is a little bit like water: it finds the easiest path. We can already see from the building Scotland fund, which is set out on the website as the precursor to the Scottish national investment bank, that three areas have been identified: housing, commercial property and business-led R and D. I would be interested in seeing where the gap has been identified for those three things. Is it an equity gap, a debt gap or a mezzanine gap? What is the evidence for the gap on those three things? It is probably true that some banks will not lend to business-led R and D, but that is not the case with our bank. On the other hand, we are not a great fan of lending against housing. Hopefully, that level of specialisation indicates some level of professionalisation in the provision of finance.

Perhaps the gap is on the equity side—I do not know. It is not entirely clear that the missions, as they are being set out, are sufficiently supported by evidence of a gap or that that gap is clearly articulated. As we have all said, there will be gaps in the market—we all believe that; we just want to see what they are, what the opportunity is and how the Scottish national investment bank proposes to fill them.

10:45

Jock Millican: Changing missions and objectives frequently will not help the bank to operate well. It would not be right to make a change to the mission according to each whim that comes along. It needs to be a long-term, patient operation.

Jackie Baillie: When you say "long-term", you are thinking about 10 years or more.

Jock Millican: Yes. Absolutely.

Gordon MacDonald: I want to ask about the funding of the bank. According to the way in which it has been set up, it will get an average of £200 million a year from the Scottish ministers. I think it was Andrew Castell who mentioned that the SNIB will be more like an investment trust than a bank. Part of the problem lies in the Treasury's recognition of it as a department, not a bank. Should the Treasury recognise the Scottish national investment bank as a bank, and should the SNIB be allowed to issue bonds or public shares?

Andrew Castell: Graeme Sands will probably mark my homework here, where appropriate, but I would say that you should be careful what you wish for. If you make the SNIB genuinely a bank, it will require capitalising and regulating as a bank, and those things cost money.

There is a related question about diversifying the sources of capital. As soon as you start taking other people's money, you are in a different place in terms of how the entity is controlled and how its governance works, the question being whether ministers and the Scottish Parliament could control it as they would if they were the sole shareholder and funder.

Nonetheless, those things can be done over time. The Green Investment Bank is an example of a bank that started off state funded and then got spun out and privatised.

Gordon MacDonald: You would not be in favour of the issuing of bonds—putting the shares aspect to one side.

Andrew Castell: I would certainly not do that for as long as there was finance available from the Scottish Government. You could consider securitising loans and selling off those securities, which would allow for the recycling of the capital that the Government is providing. There are a number of financial engineering options that could achieve the aims that you might want to pursue in using external capital that would not involve taking it into the bank itself.

Gordon MacDonald: I note that, if the SNIB remains recognised as a department, it needs to

“secure a dispensation from HM Treasury to have the flexibility to manage, retain and carry-forward cash balances over financial year-ends”—

given the headroom that the Scottish Government has for carrying forward. What impact would it have if the SNIB were not allowed to carry those balances over?

Andrew Castell: I was a non-executive director of Highlands and Islands Airports Ltd for six years, and HIAL built up a reasonably sizeable cash reserve with a view to expanding Inverness airport. Sadly, it had that reserve taken off it—because the Treasury finally noticed it, I think.

I suspect that the bank will turn cash into investments quite quickly as it comes through, so the risk of its being caught with a sizeable cash balance at the end of each fiscal year is probably quite small. However, I suspect that it would make everyone's lives easier if the bank were to secure that dispensation and be able to hold cash without it being taken away come the beginning of April each year.

Gordon MacDonald: You mentioned the Green Investment Bank. The British Business Bank got a dispensation that was similar to what the SNIB is looking for, did it not?

Andrew Castell: I do not know.

Angela Constance (Almond Valley) (SNP): Does the panel have any views on the bank's remuneration policy? The committee has heard a range of views on the matter, as you would expect. On the one hand, some witnesses have said that, as the bank will be operating in the financial services sector, the terms and conditions need to reflect that sector. Other witnesses have put forward the argument that, as the bank is a public body, there needs to be public confidence, and that senior personnel should be paid as public servants, as opposed to private financiers. Who would like first dibs on that one?

Andrew Castell: My views on this are not always very popular. If the employees of the bank are going to enjoy the advantages of being in the public sector, which are no compulsory redundancies and perhaps receiving a defined benefit pension entitlement, I do not see why they need to be paid the kind of salaries and bonuses that people in banks have been and continue to be paid. There is a risk premium associated with that kind of employment, which is quite precarious.

Referring to the pooling of local government pension funds that is happening south of the border and is being discussed north of the border, the asset management firms that have been formed to run the pooled pension institutions are concluding, more often than not, that they do not need to pay the big salaries to attract quality people. There are definitely precedents for having institutions such as SNIB fall within a government pay mandate.

Angela Constance: I would say that that is a very balanced view, as opposed to an unpopular one, but other members of the panel will perhaps wish to add to that.

Jock Millican: It is a matter of ensuring that the rewards come in different forms. As Andrew Castell said, no one in the private sector can even hope for the pension thing these days—it is all gone. It is about balancing these things. You must ensure that you are getting the right people to run the bank. It is no use saying that we will have a certain level of remuneration if we end up with people who are not capable of running the bank.

Angela Constance: I have not heard anybody suggest that we should be recruiting unqualified people. I wonder whether other members of the panel have anything further to add.

Graeme Sands: I will link this to previous comments. I will not comment on whether public or private sector pay is appropriate, as I do not entirely know what we are talking about within those two ranges. However, the mission and purpose of the Scottish national investment bank must be bold, ambitious and clearly set out and embedded within the culture of the organisation. I tend to agree with Andrew Castell and Jock Millican that, if the purpose is clearly embedded and understood in the organisation, it should be possible to attract the right people, who are rewarded by executing that purpose and not just by the pay cheque.

Angela Constance: So high-calibre people have a range of motivations that they wish to see fulfilled in their employment.

Graeme Sands: Yes.

David Grahame: I endorse that. It is not entirely surprising to get that view. The whole of the business angel community is partly driven by putting something back, as well as by investing. We are not at the red-in-tooth-and-claw end of things.

The bank will need quite a wide range of skills, particularly if it gets into dealing with third sector issues and so on, so it is important that it has a breadth of professionalism and credibility for dealing with those bits of the market that it is interacting with.

Angela Constance: Could you give some examples of the breadth of professionalism that would be required?

David Grahame: If we were to ask the personnel to assess a social investment proposal, for example, that would probably not use people with quite the same skills as those who would consider pure VC. We would not want to have the bank compartmentalise, but it looks like it will have to cope with quite a wide range of tasks.

David Ovens: I broadly agree with everybody. The senior management of the bank will not have an easy role, so they will need to be appropriately remunerated. That should be referenced to public sector pay policies, but without necessarily sticking to them.

I caution against a bonus culture. If the work of the bank is all about the long term, any related incentives should be appropriately pegged and longer term in outlook.

Andy Wightman (Lothian) (Green): It is now common for investment funds, and indeed sovereign wealth funds, to have ethical policies. There is no provision for that in the bill, but I wonder whether you think that the bank should have an ethical policy, for example on things that it will not invest in, such as fossil fuels, tobacco and arms, or is that something that is best avoided?

David Grahame: The whole trend in society is towards ethical finance. That is certainly not something that we have a problem with. Nearly all the public sector sources that we interact with have limitations. Again, it comes back to the clarity of definition, particularly of terms such as "ethical". That should not be a matter for interpretation by officials. We would have no problem with the bank having a clear ethical policy.

Andrew Castell: Pretty much everyone has an ESG clause in their investment management mandate, in their articles or whatever.

Andy Wightman: Sorry, what is an ESG clause?

Andrew Castell: Ethical, social and something or other—essentially, it is ethical investment. Everyone just calls it "ESG" and it gets lost in the acronym—apologies for that.

Some things are clearly bad: you would not want to be investing in terrorist organisations, drug pushers or whatever else. Then, there is tobacco, which is the next best thing, and so on. As you go along the spectrum, there will be areas of greyness. An example that was cited previously involved an oil and gas company that is trying to transition away from oil and gas and is developing low-carbon technologies. Is that something that should or should not receive some assistance from the bank?

Andy Wightman: We also had an interesting discussion about alcohol last week.

Andrew Castell: Yes. It has always intrigued me that Scotland is fixated on how bad alcohol is, yet it is one of our major exports to the rest of the world—but there we go.

On the specifics of the objects of the bank and how its constitution works, one very good maxim in life is, "Always do the right thing." Directing the bank to be ethical in its approach, as an overarching objective, would be the way to do it—and then directing the management, at a more specific level, on what industries or activities are considered to be unacceptable for it to concern itself in. The bank could report annually, or however frequently makes sense, on how it is observing the more detailed guidance.

Jock Millican: I agree with Andrew Castell. It is important that the bank is given guidelines to work with on what is deemed to be ethical or not ethical at the time. Things change over time: what was ethical 20 years ago may not be ethical now. It should be down to ministers to give that guidance, I would say.

Andy Wightman: Those were fairly clear answers.

I will move on to another topic that we have been exploring: the proposal that there be a group to advise ministers, who will be the sole shareholder of the bank. The implementation plan, I think, suggests that the chair of the advisory group should be a non-executive board member of the bank.

The bill makes no provision for an advisory group; it is just something that has been suggested. What are your views on such a group? Would it be useful? Should it be incorporated either in a section in the bill or through something in the articles of the bank?

Andrew Castell: When it comes to the governance of any kind of undertaking, the fewer groups whose instructions you are expected to follow, the better. As regards the articles of SNIB and the enabling bill and so on, it should be very clear that the bank answers to ministers. Everyone knows, then, what the line of communication is.

11:00

As I understand it, the advisory group is as you have just described it, in that it is there to help ministers understand what SNIB is doing, what it might need to do, and so on. That channel of communication should therefore be between ministers and the advisory group. I think that it would confuse matters to enshrine the group's status in the constitutional documents for the institution. That is simply because it may be that, over time, ministers feel confident enough that they do not need a bunch of people whispering in their ear about X, Y, and Z and can look after the bank themselves.

Andy Wightman: To be clear, if such an advisory group were to be appointed by ministers—no such provision having been made in the bill—you would not wish the chair of that group to be sitting on the bank's board.

Andrew Castell: There could be very good reasons for that to happen, but that can be dealt with, as the appointment of directors to the board is in the gift of Scottish ministers. If they decide that they would like the chair of the advisory group to be a non-executive director of the bank, it can happen. I do not think that you need to make provision for that in the articles.

Andy Wightman: Are there any other views?

Jock Millican: I concur with those of Andrew Castell. It is very important that the advisory board does not directly influence the bank, but does that through ministers.

David Grahame: There could be an opportunity to get some wider value from an advisory group. If all that it did was channel a variety of opinions to ministers, it could be a sort of rolling consultation medium or focus group. If it were well structured and well led, its bringing together a whole host of people who would not normally sit down together and interact would hopefully lead to some better understanding.

Of course an advisory group would be entitled to feed through independent views. On occasions when the group came to a joint understanding of things that it wished to put to ministers regarding performance or future development, it could give a very powerful message.

Andy Wightman: I will pick up on a few things that were said earlier. Graeme Sands, you said that you thought that we should de-emphasise commerciality in the bank, yet that is at the heart of the main statutory article. Could you clarify that view?

Graeme Sands: In our written consultation response, we emphasised that we do not believe that the bank should compete with existing commercial options. We discussed that at some length. The deputy convener asked a question about the early years of SNIB's establishment and the commercial expectations for it.

Our view is that, if the Scottish national investment bank is going to step into areas that are already covered by commercial equity or commercial debt finance, that is not desirable. That is not SNIB's objective, and it would be unlikely to lead to the best outcomes for taxpayers.

It is a matter of the level of emphasis. I fear that, if we emphasise aggressive rates of return, especially in the early years, or if we emphasise a very commercial model, it could be hard to sustain the Scottish national investment bank as an entity. Clydesdale Bank is very supportive of its establishment, for all the long-term reasons that are set out in the consultation document. We see a danger in trying to make the organisation too commercial too quickly.

Andy Wightman: That is helpful.

I will move on to the subject of missions, which are central to the concept of the bank, and to the advice that has been given to ministers by Mariana Mazzucato and others. Provision is made in section 11 of the bill for setting missions. By their nature, missions will be cross-sectoral. As one of you observed, they are reliant on not just what the bank does, but what a lot of other people do.

Some months ago, I visited a business involved in an innovative heating technology that can potentially contribute to rapid reductions in fuel poverty levels. The business was on the point of leaving Scotland and moving to Zürich in Switzerland, until it got a contract from a housing association. That is the kind of example that I have in mind among a portfolio of investments that might help to tackle the big challenges around fuel poverty or indeed low carbon. That is what I have in mind when we talk about missions. Is that the kind of mission that you understand by the term? Do you have others in mind?

David Ovens: Let us consider the transition to a low-carbon economy as a mission, bearing in mind the premise that SNIB is primarily a financing organisation. As Graeme Sands indicated, the missions need to be evidence based. I think that all of us around the table would agree that the transition to a low-carbon economy, based on evidence, is a good thing that SNIB should be supporting.

We then need to recognise that getting from A to B will take a long time for that mission, and it will be a challenge to leverage in private conventional capital. In that sense, we are addressing a market failure. SNIB has to be focused when it comes to the financing.

As David Grahame said, other agencies can be involved in the other aspects. As far as personnel are concerned, there is Scottish Enterprise, and social enterprises could be involved in all aspects. I see SNIB's role as being at the heart of the financing aspect of that mission-led approach.

Graeme Sands: Building on that, and getting more specific, it might be that the real problem in the example that you outlined, Mr Wightman—I am not saying that it is, but it could be a problem—lies in a lack of confidence in public sector or quasi-public sector procurement. That might be a useful place for the Scottish national investment bank to deploy guarantees.

If it were up to me, I would try to make the missions very precise. For instance, the mission might be to address a lack of public sector procurement confidence in small companies or smaller businesses that are trying to transition from active technologies to a low-carbon economy. I am simply using this as a hypothetical example. Let us say that we have seen a market gap—a lack of guarantees—so one of the bank's missions would be to provide guarantees that close that market gap and achieve the end aspiration. That is the level of specificity or detail that I would hope to see from the Scottish national investment bank's management in executing the missions.

Andy Wightman: However, the missions, as they are described in the bill, are to be set down in

"a document describing the socio-economic challenges that the Bank is to seek to address."

There is no great specificity in that. Are you suggesting that the missions themselves should be quite specific and detailed?

Graeme Sands: At the risk of repeating myself—I have said it a couple of times—I think that the clearer the missions are, the less chance there will be of the bank's operations straying into things that are not market gaps and, ultimately, the more successful the bank will be in the long run.

Andy Wightman: Andrew Castell, I think you said earlier that the missions would be subject to the scrutiny of the Scottish Parliament. In fact, there is no provision for that whatsoever.

Andrew Castell: Is there not?

Andy Wightman: No.

Andrew Castell: My apologies.

Andy Wightman: Parliamentary approval is required if the bank's objects are to change, but the missions are to be set by ministers and communicated to the bank, with a copy of the documents to be laid before the Parliament.

Do you see merit in providing Parliament with a role in scrutinising the missions, and possibly even in resolving to agree or disagree with them?

Andrew Castell: Much would depend on the style of government. We have touched on this a few times. One of the challenges around any kind of patient institution is that there are fairly lengthy timescales during which any number of lumps of rotten fruit will be flung from the media or wherever else. If missions are subjected to quality control—considering how they are formulated, the time spent working out how to measure success and what success looks like, and how to communicate clearly to the agencies and entities that are responsible for delivering them—that will increase the chance of each mission being successful rather than ending up as just another initiative that petered out because no one knew what they were supposed to be doing.

If greater involvement by MSPs—rather than just leaving the Executive to it—were to result in better-quality missions in terms of how they are framed, that would seem like a good idea to me.

David Grahame: At the parliamentary level, we suggest scrutiny and comment rather than full approval, which might be too cumbersome a process. Although ministers set down the bank's missions, there is a flip side. I think that I am right in saying that, under section 12 of the bill, the bank has to come back with proposals for how it will fulfil its missions. In our parlance, that is asking the bank to produce a business plan, so there could be some discussion on how, and by whom, such a plan should be approved.

Andy Wightman: Section 12 is quite interesting. It states:

"The Bank must send a mission report to the Scottish Ministers … within 3 months of receiving a document … explaining how"

it

"intends to respond to the strategic missions".

Three months is a very short turnaround time; one would hope that the bank would get an advance briefing of a new mission. The provision does not strike me as encapsulating the production of a business plan or anything like that—it seems to require quite a high-level explanation, in very broad terms, of how the bank intends to go about fulfilling the mission.

David Grahame: I think that it would depend on the level of approval that ministers would want. If they want line-by-line approval, the time period may have to be longer.

Andy Wightman: Are there any other thoughts?

Andrew Castell: I would not like to be on the receiving end of a three-month deadline to report on how I am going to implement a mission for a multi-agency project. If I was sitting in the bank and there was a narrow focus on the bank alone being 100 per cent responsible for delivering against the mission, three months might be just about enough. However, if I had to liaise with half a dozen other parties, it would sound like a very short time period indeed.

That brings me back to the point that a high-level approach is better with this type of bill. It would not be helpful to set random—and possibly not very carefully thought out—deadlines and timescales in the bill.

Jamie Halcro Johnston (Highlands and Islands) (Con): Does the panel feel that existing capital investment is focused more on the central belt and in urban areas? Conversely, what funding mechanisms exist for rural businesses, and how well are such businesses currently catered for?

Jock Millican: It depends. The vast majority of businesses that we are looking at are high-growth businesses that have quite often come out of universities. There is therefore an emphasis on those areas where the universities are, which is where the talent is. We tend to focus on those areas, but we also look at businesses from all over the country to see whether they are appropriate for us. Some businesses come from the universities and set up in regional areas. We have just been looking at a business that came out of a university and is now setting up in Oban; whether we invest in it is another question, but we are looking at it quite seriously. If a business comes forward, I do not think that there are any constraints in what we look at based on region or area.

David Grahame: We have operational groups in the Highlands and in the Borders, both of which were set up locally by people with a view to giving something back. To be fair, they have struggled to find demand in those areas. Support for the stimulation and development of demand is important, but that is a role for other agencies rather than for the bank.

Jamie Halcro Johnston: Is it a role for the enterprise bodies and local authorities?

David Grahame: Yes. Our colleagues in Highland Venture Capital are quite frustrated. They have been there for a long number of years, and they have one investment in the Highlands, with all the rest in the central belt.

Andrew Castell: It brings me back to what I said earlier: there are plenty of viable and perfectly sensible businesses, but they will not always be of interest to people with a venture capital mindset, who really want high-growth and high-value creation potential. Those high-value businesses, by their very nature, generally require highly skilled and highly qualified staff, who are available in great numbers in the central belt but in rather smaller numbers in, say, Fort William.

11:15

Dean Lockhart: I have a general question. Is there a national investment or development bank model overseas that we should look to as an example of best practice, or should each bank be tailored to the individual needs of each economy?

Jock Millican: As one or two of us mentioned earlier, the Scottish Investment Bank model is viewed with envy across the rest of the world. We have people who have been working with the World Bank to institute that exact model in other parts of the world. From the co-investment perspective, we have a very good model in Scotland. With regard to SNIB's wider remit, things may be done differently elsewhere, but I am not aware of any specific examples.

David Ovens: I completely echo those comments. Again, I make a plea that you do not change any aspect of the Scottish co-investment fund as it currently operates. However, we should look to the British Business Bank and other institutions and pull out some of their initiatives. The British Business Bank is currently using the enterprise capital funds model for investment in venture capital funds. It invests in the funds, and then sets a target for them to invest geographically. That is a useful initiative to which SNIB could look in the future, particularly in relation to the further stages of a company's funding journey.

The Convener: As there are no further questions from committee members, I thank the panel members for coming in to provide us with their views and their short forms for various matters, such as the "mezzanine gap"; I had not heard of that before.

11:16

Meeting continued in private until 12:19.

This is the final edition of the *Official Report* of this meeting. It is part of the Scottish Parliament *Official Report* archive and has been sent for legal deposit.

Published in Edinburgh by the Scottish Parliamentary Corporate Body, the Scottish Parliament, Edinburgh, EH99 1SP

All documents are available on
the Scottish Parliament website at:

www.parliament.scot

Information on non-endorsed print suppliers
is available here:

www.parliament.scot/documents

For information on the Scottish Parliament contact
Public Information on:

Telephone: 0131 348 5000
Textphone: 0800 092 7100
Email: sp.info@parliament.scot

The Scottish Parliament
Pàrlamaid na h-Alba