consultancy engineering business environment

State Investment Bank

Challenges and rationale behind a State Investment Bank

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Series introduction

This series of papers will examine how the UK can secure much needed investment in its social and economic infrastructure in the coming years.

Achieving this is important. Infrastructure has been highlighted as a primary driver for economic growth, as well as a means to deliver the UK's goal of a hi-tech, low carbon and globally competitive economy. However, the UK is acknowledged to have both a shortfall in quantity (estimated by some at £434 billion[1]) and quality (the UK was recently ranked 24 for the overall standard of its infrastructure by the World Economic Forum[2]), hampering efforts to achieve these goals.

The timing of this series is also important in relation to proposed solutions to the UK's infrastructure challenges. At the UK level, the National Infrastructure Plan is moving from its formative stage to delivery. Infrastructure solutions in the Devolved Nations are also taking shape, with examples, such as the formative Welsh Infrastructure Investment Plan being developed.

Developing sustainable models and sources of funding and financing for these proposed solutions, -especially in tough economic times with a restricted public purse- will require new thinking. Helping to identify these new models and sources of funding and financing and removing the blocks and challenges to them is the aim of this ACE investment into infrastructure series.

This series of papers will explore a range of options available to government as it looks to secure investment and raise the UK's standing for infrastructure standards. These include the development of the Green Investment Bank, the potential for pension fund investment, new public-private finance models and alternative methods.

Abstract

This paper is the final paper in ACE's infrastructure investment series and explores in more detail the rational and practicalities of establishing a State Investment Bank.

Contents

Key findings

A State Investment Bank could play an important role in long term economic policy

- A State Investment Bank should not be seen as a short term solution for economic growth or as a tool to prevent future recessions. It is a facilitator to the market for future growth, competitiveness and economic potential.

- A State Investment Bank would have a challenging role, in that it has to balance its activities within the grey space between commercial (viable) and uncommercial (unviable) projects. Its role is therefore to facilitate investment whilst not crowding out private financing where it would have otherwise been available.

- One of the issues that have been reported as part of the PFI review is that of getting pension funds and traditionally low risk profile investors into the earlier stages of investment. A State Investment Bank could also play a role in attracting such finance, for example as the centralised body. With a larger remit it would also be able to issue bonds at varying maturities larger than that of single projects. This could be done across multiple sectors to achieve a variety of financial products that would suit a wide variety of investors.

A State Investment Bank would help to stimulate housing supply

- A State Investment Bank being aware of its limitations is important. The EIB demonstrates that even with its large size, budget and wide ranging experience, it continues to focus on its role as a lender, and its ability to facilitate finance in successful projects. This is important as it stops the bank operating inefficiently in areas, utilising market expertise rather than seeking to be an expert in every sector.

- Whilst the inclusion of housing has been suggested for a State Investment Bank, it would also add a significant area where additional expertise would be needed, and therefore may result in the State Investment Bank's remit being spread too wide.

- Ashford in Kent is a good example of how infrastructure can facilitate housing growth. Looking at the effects of HS1 on the area it passes through, Ashford experienced the largest population growth in the South East,[3] growing 27% between 1981 and 2006. Ashford's population is projected to be above 150,000 by 2031.9 HS1 has generated 7,500 extra jobs, reduced journey times by 46 minutes and increased house prices by £203m in total.[4]

- Housing investment does not therefore need to be co-ordinated and leveraged from a central position. The initial investment would facilitate and allow for circumstances in which local authorities have an increased number of opportunities to negotiate with developers to improve local communities according to their specific requirements.

Given the importance of SME finance, it should remain separated from the task of investing in infrastructure.

- There are international examples where SME finance facilities and infrastructure financing operations are combined in a single entity, such as the Brazilian Development Bank (BNDES), the European Investment Bank (EIB) and Kreditanstalt Fur Wiederaufbau (KfW), default rates suggest that an SME portfolio can be managed effectively separately.

- Whilst both the issues surrounding infrastructure investment and SME access to finance are important and should be tackled, there remain a number of tensions if combined within the same body.

- An infrastructure and SME Bank would require teams with very different skill sets. Commercial pressures will build on the poorer performing activity, encouraging activity to shift, whilst also increasing the likelihood of political pressure to abolish, or artificially influence the poorly performing area. Such political interference would detract from the State Investment Banks key mandate of investment based on sustainable financial principles.

- For example, infrastructure investment requires the raising of significant capital, over a long period, leveraging significantly on equity and debt investors. Following this, arrangements and regulatory environments need to be in place to provide funding for the service and provide a return to the investor. Whereas, the financing gap for SMEs is by comparison to infrastructure investment, small scale lending with niche risks and is also likely to be over a significantly shorter period.

- An SME finance institution must address cash flow issues, not just finance. For the smaller sized companies, cash flow and not capital for investment is the main issue that constrains growth (such as hiring additional employees). If undertaking an activity such as providing overdraft top up guarantees (which could be charged at a small fee) government could relatively quickly and inexpensively unlock significant investment and growth.

- There has been a shift towards such a standalone SME finance institution existing, with the Business Secretary announcing at the Liberal Democrats Party Conference that the government would create a British Business Bank.

State aid approval is required for a State Investment Bank

- To set up a State Investment Bank the UK Government would need to gain approval from the European Commission under state aid rules. These rules are put in place to ensure that national governments don't provide uncompetitive subsidies to national industries. As such the European Commission would need assurances that a State Investment Bank was not simply be undercutting commercial banks, or unfairly subsidising specific activities.

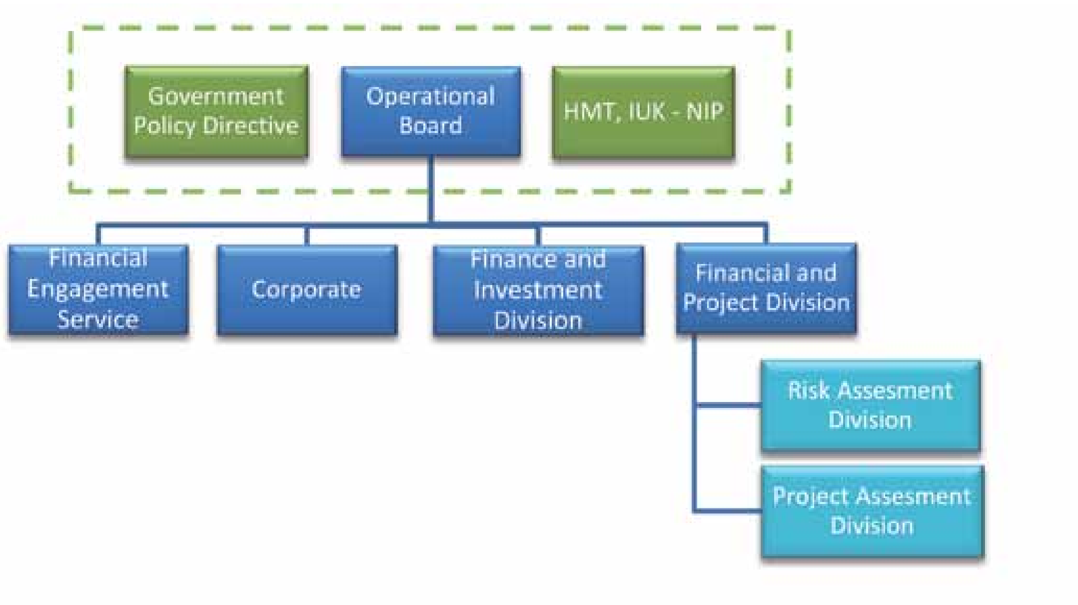
- State aid rules do make exceptions for areas where it is accepted that market failure occurs. One of these areas would be that of SME financing given its recognition as a longstanding issue.

A State Investment Bank is not a one stop shop to fix for endemic investment problems

- It is important that a state investment bank is not seen as a one stop shop fix for endemic investment problems. The institution will still have to operate within the context of wider political and economic policies. It is also important that aspects of government policy are also consistent. Failure to provide a wider stable policy framework is likely to limit the degree to which a State Investment Bank can leverage finances and ensure value for money.

- The State Investment Bank's involvement in projects will mean that it has to be able to effectively assess and manage the financing, asses the risks involved in the construction and operations stages and look at the potential sale of the asset following completion.

What might the structure of a State Investment Bank look like?



The following would be undertaken as part of this structure:

- The Financial Engagement Service would be positioned within the State Investment Bank to prepare and help smooth the transition of companies/ investors from that of enquiring about advice/investment to that of being able to access and apply for investment funds. Following the financial crisis and given the likelihood of changes to the regulatory regime, this department would be able to filter down the advice and guidance from the purely financial regulatory bodies to businesses.

- The Finance and Investor Division would liaise with other potential investors and perform operations such as raising funds through bond issuance.

- The corporate section of the State Investment Bank would primarily deal with implementing the operational procedures as decided by the Operational Board given their mandate and political discussions.

- The Financial and Project Division of the State Investment Bank will be key. It is within this unit that projects are submitted, assessed and finance approved. Ensuring that a State Investment Bank has the necessary skills required to operate such a unit will be key to the operational success of the institution.

A State Investment Bank needs to make profit and invest returns.

- Part of the bank's mandate must be the ability to be able to make a profit. This provides it with the means and credibility to interact with the public sector. In addition, it ensures it operates in a way that is not only fiscally responsible, but also has direct benefits in ensuring its long term stability of reserves and financing.

- Whilst profit is important, it is also not the primary goal of this institution. As such, its remit should not focus on profit maximisation. For example, EIB's Annual report for 2010[5] it states: The Bank's primary objective is not the maximisation of profit. Its statute stipulates that interest on loans "shall be calculated in such a way that the income therefrom shall enable the Bank to meet its obligations, to cover its expenses and risks and to build up a reserve fund…"

- It is important that a State Investment Bank provides loans on a sound basis, earning income off future repayments, which enable it to reinvest and further fund projects.

Building a skills base for a State Investment Bank is vital

- For a State Investment Bank to be successful it must build an expert skills base to assess projects, risks and implement financial tools. If a State Investment Bank is to be constructed as a new institution this process will take time.

- The Government could speed up the process of building skills and also ensure the future effectiveness of the organisation by using the existing skills base already employed as part of the Green Investment Bank and/or by exploring how existing bodies such as the UK Export Finance could play a wider role as part of the State Investment Bank.

- For example, UK Export Finance aid exporters by providing guarantees, and reducing the risk profile on projects. Whilst a UK State Investment Bank would be able to extend its product offering to include the financing of projects, it could utilise such expertise. If UK Export Finance's resources and expertise in both reducing risk and its links to international markets were utilised in a State Investment Bank, it could become a powerful tool for investment.

The change in financial regulatory landscape needs to be factored into a State Investment Banks design

- It would be important that a State Investment Bank is seen to have the full backing of the BOE, FSA and Government to provide confidence to investors.

- Thought needs to be given to how Government would review and monitor investments from a State Investment Bank. For example, the Office for Budget Responsibility (OBR) currently reviews fiscal spending. The OBR, National Audit Office (NAO) or the BOE could play a similar role in providing confidence in the assessments of the State Investment Bank.

The scale of capitalisation for a State Investment Bank is important

- Currently there are few estimates as to the scale that such a capitalisation would need to be. For example, IPPR estimates that £40bn of capital could be injected into a State Investment Bank over a four year period, leveraging private investment at a ratio of 2.5:1 resulting in the institution having a balance sheet of £140bn at the end of the period.

- To put this figure in the context of the UK's national output, if we take the four year period 2008-2011, the UK's output equates to £5,726bn[6] if the State Investment Bank had been running over this period and leveraged the anticipated capital it would have equivalent to 2.4% of total output over the period.[7]

- The CBI estimates[8] that public sector net investment of 2.25% GDP is required to maintain services in the long term whilst maximising growth and ensuring international competitiveness. As can be seen from this estimate whilst a State Investment Bank would not replace government investment it could contribute significantly to the UK's capital investment position, helping it to restore its long term investment profile.

The banking levy could provide a significant degree of the capital for a State Investment Bank

- Using the funds from the banking levy to help capitalise the State Investment Bank could provide a significant contribution towards its establishment. The levy in 2012 is estimated to raise £2.6bn. If each year's levy was put towards a State Investment Bank by 2017 the government would have built up £15.6bn in capital for investment. Given leverage ratio of 1:2.5 the government could leverage 39bn which alongside its original investment would secure investment of £54.6bn of funds for investment into infrastructure. Such investment would be seen as a positive outcome given the support taxpayers provided during the financial crisis.

A State Investment Bank requires a solid plan as to its capitalisation process

- Market confidence in a State Investment Bank is essential. This confidence needs to be bolstered by Government by ensuring it has a number of reliable funding streams to capitalise the bank and ensure future investments. Using multiple capitalisation mechanisms reduces the political risk in any one area, whilst a credible plan also provides the confidence that government backs the investment stream.

- As can be seen from the diagram, by combining a number of revenue streams the government can build a significant pool of capital for a State Investment Bank. Within this it can account for its public debt profile/ forecasts, inflationary pressures, economic growth expectations and importantly, build market confidence in the institution's future pipeline and project delivery schedule.

- This schedule would align with the National Infrastructure Plan to further build confidence and delivery. This over time should boost the UK's international competitiveness and improve its economic growth prospects.

Could the government scale down Royal Bank of Scotland (RBS) into a State Investment Bank?

- UK Financial Investments Ltd (UKFI), which was formed by the government to manage its investments in financial institutions, has a clear mandate to eventually dispose of the Government's shareholdings. This has to be done in a way that does not create instability within the financial sector, and must ensure competition within the sector.

- Whilst the Government holds a significant number of RBS shares, the Government has maintained that it does not wish to significantly influence the commercial and operation decisions taken within the bank. Within this there will be an underlying wish for taxpayers to make a return on the bailout funds committed to RBS as part of its bailout, at a cost of approximately £45bn.

- Competition laws are likely to prevent such a large intervention into the financial sector. It is therefore likely that if the UK were to use RBS for the formulation of its State Investment Bank, alongside the UK Government's current involvement in NS&I and Lloyds, that there would be significant issues to resolve with regards to competition legislation on both a UK and EU level.

- As such, building the State Investment Bank out of an entity such as RBS may prove to be too complex, time consuming and costly for the taxpayer.

A clear roadmap would be needed to scale up the GIB to a full State Investment Bank.

- Having gone through the process of gaining state aid approval, Government would be wise to use this institution as effectively as possible in a wider variety of sectors where market failure occurs.

- One of the key aspects for market confidence is the provision of a clear roadmap. This should outline in a transparent manner policy objectives, investment areas, and funding changes. For a State investment Bank to be successful the market requires confidence in its longevity. If this is not provided policy and funding uncertainty remains.

- For example, if we take a number of possible developments, this roadmap outline would look like this:

  2012
  Establishment of Green Investment Bank – capitalisation £3bn

  2014-15
  Green Investment Bank given facility to borrow.

  2014-15
  Target investments set for a five, 10 and 25 year period in each sector reported.

  2016
  The Green Investment Bank begins to shift its 'green' agenda to one of sustainability encompassing all aspects such as use of resources, future proofing, emissions, international competitiveness etc. Application for State Aid approval for full State Investment Bank operations in preparation for 2017.

  2017
  The Green Investment Bank remit is to be expanded to that of wider infrastructure projects, forming a State Investment Bank. This would occur on a sector by sector basis building skills in the relevant areas with regards to financing, returns and project risks. Projects in these new fields are funded by the capitalisation proposed earlier in this report, with borrowing not permitted in these new areas, limiting risk while allowing skills to build.

  2018
  Target investments updated.

2019
The State Investment Bank is allowed to borrow against all areas of its operations, providing loans for projects.

2020
Explore the possibility of the State Investment Banks remit being expanded to include implementation of National Infrastructure Plan. This would provide both political and market certainty over the delivery of infrastructure linking policy closer with delivery, funding and efficiency.

A State backed Investment Bank

Whilst it has been demonstrated that the Green Investment Bank (GIB) would provide benefits in terms of driving investment there are concerns that its remit must not be made too narrow.

For example, the Aldersgate Group[11] say that too narrow a remit would result in the GIB not being successful in allowing both SMEs and communities to help themselves and the UK as a whole to deliver energy security and meet our carbon and energy targets.

Beyond the current remit of the GIB there are a number of organisations (such as the IPPR and TUC) that feel that remit should be expanded further with the establishment of a State Investment Bank. This would allow the investment benefits to be applicable to a wider variety of investments and circumstances.

Investment banks already operate under wider remits in areas such as in the Nordic region (Nordic Investment Bank) and even on a widening EU scale (European Investment Bank).

In this paper the term State Investment Bank (SIB) will be used as a generic term for the bank that would be formed, with the British investment Bank constituting the same body.

Whilst economic conditions remain challenging a State Investment Bank could be used to improve long term growth prospects, and potentially offset the contraction effects of fiscal consolidation. In this respect the task of the State Investment Bank would not be a simple one, but it would be welcome at a time where government has constrained budgets and also needs to promote growth. This is because the government would be able to use its more limited resources to leverage further financing from the private sector.

However, it is important to recognise that such an institution would not be set up overnight, and that building long term investment institutions takes time. The IPPR estimate[10] that at a minimum it would take two years from ministerial approval to the development of a State Investment Bank becoming operation.

One of the key messages the establishment of the State Investment Bank would send is that of confidence, with the financial sector currently struggling to recapitalise following the financial crisis and impact of the sovereign debt in the Eurozone. A State Investment Bank would therefore help to address not only the current constraints with financing but also the longer term mismatch between financial returns, social economic returns and the balance between short, medium and long term investment and competitiveness. Whilst a State Investment Bank can help to facilitate investment and address market failures, it's natural position should be viewed as a long term investor.

Therefore, a State Investment Bank should not be seen as a short term solution for economic growth or as a tool to prevent future recessions. It is a facilitator to the market for future growth, competitiveness and economic potential.

However, as we noted for the GIB in the last paper in the series, a State Investment Bank would have a challenging role, in that it has to balance its activities within the grey space between commercial (viable) and uncommercial (unviable) projects. Its role is therefore to facilitate investment whilst not crowding out private financing where it would have otherwise been available.

Importantly, there are a number of international institutions that have been set up that could provide a template as to how a State Investment Bank could operate. For example, the Centre for Global Studies paper[11] puts forward the following options:

- The World Bank
- The European Investment Bank
- The Nordic Investment Bank
- The European Bank for Reconstruction and Development
- The Asian Development Bank
- Germany's national investment bank - KfW
- The Japanese Development Bank
- The Korean Development Bank
- The BNDES of Brazil

Of these it is found that the KfW, the Nordic Investment Bank (NIB) and the European Investment Bank (EIB) would be considered the most appropriate benchmarks for a State Investment Bank.

These institutions, unlike the UK's newly formed Green Investment Bank have been operating for a substantial period (e.g. Nordic Investment Bank – 1975, European Investment Bank – 1958). This therefore not only demonstrates their potential for long term investment, but also as a financially sustainable institution over time.

For example, the Nordic Investment Bank despite being one of the smaller State Investment Banks has a AAA rating and 20 billion worth of loans on its books. Over its 35 year operation the IPPR reported that Nordic Investment Bank has experienced steady growth and has made an average return in excess of that which could have been obtained by investing in government bonds[12].

Looking at a more sizeable example, the European Investment Bank's 2012 annual funding programme is reported as being 60 billion.[13] At the end of 2011 its balance sheet revealed that it had total assets of 471.8 billion, which was up 52.0 billion on the previous year. The EIB also made a profit of 2.29 billion on its investments up from the previous year's figure of 2.12 billion.

There is one interesting differential between these two institutions. The Nordic Investment Bank is the only institution of its kind to pay dividends to its shareholders. Whilst this could potentially limit the degree to which the Nordic Investment Bank can further leverage and reinvest in projects, it also instils a greater degree of financial discipline within the organisation.

One of the key issues currently is that the State Investment Bank must be able to attract private investment, so that it does not create any undue strain on government's books at a time of constrained expenditure.

As such, although the State Investment Bank may operate in a similar manner to the currently proposed Green Investment Bank (GIB), there will need to be further detailed study on the scale of government support required and the mechanisms through which it can achieve the greatest leverage of private funds.

Nick Tott was commissioned by the Labour Party to explore the case for a British Investment Bank. This paper also explores a number of international comparisons including those mentioned previously (e.g. KfW). However, the paper also considers housing as another potential area in which a State Investment Bank could be used to facilitate growth.

- "[The State Investment Bank] could have [a] 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.[14]"

Whilst the inclusion of housing may be potentially beneficial, it would also add a significant area where additional expertise would be needed, and therefore may result in the investment bank's remit being spread too wide.

For example, although there have been some projects that have utilised EIB funding for house building (under its urban regeneration scheme) these generally occur through third parties such as The House Finance Corporation Limited[15] (THFC). This institution (THFC) in conjunction with housing associations provides the route and expertise to market for the funds.

A State Investment Bank being aware of its' limitations is important. The EIB in the example above demonstrates how even with its wide ranging experience, it continues to focus on its role as a lender, and its ability to facilitate finance in successful projects. This is important as it stops the bank operating inefficiently in areas, utilising market expertise rather than seeking to be an expert in every sector.

So whilst traditionally there have been a number of attempts to link various types of infrastructure together, it is important to recognise not everything can be done under one operation.

Within this there are also varying interests for example:

- Government prefers that areas such as brownfield sites are re-developed; whereas, the private sector favours low cost, high land value sites as it preference for redevelopment.

- The Government as part of its housing policies tries to incentivise the provision of social/low cost housing. However, this does not maximise profit for a house builder.

- Whilst new housing provision in the UK is important, refurbishment of existing properties is increasingly more of an issue. However this carries greater risk, higher costs and if in low price areas is unlikely to yield significant returns.

- The provision of infrastructure such as roads, rail, schools and hospitals and their integrations into existing infrastructure is important. Whilst government will want to maximise the contribution made by the private sector, the private sector will always try to minimise such costs unless the value of such investment can be captured in the eventual selling price.

These examples show how trying to balance all these interests is difficult. This is therefore likely to be further complicated if another entity were to be involved in the financing and development of housing sites. As such, a State Investment Bank would therefore need expertise to assess all of the above political and economic risks to make accurate judgments as to investment outcomes and returns. This is a significant task and would be especially difficult during the initial phases of operation for a newly established State Investment Bank.

Such concerns have also been raised elsewhere. For example, the IPPR paper states "there is a risk, however, that establishing an institution that aims, from the start, to tackle so many problems would result in failure on all fronts."[16]

If a State Investment Bank were to concentrate on roads, rail, energy and water/waste, housing infrastructure will follow as investors and companies try to make returns from added land values. Ashford in Kent is a good example of this happening:

- Looking at the effects of HS1 on the area it passes through, Ashford experienced the largest population growth in the South East,[17] growing 27% between 1981 and 2006.

- Ashford and HS1 has generated 7,500 extra jobs, reduced journey times by 46 minutes and increased house prices by £203m in total.[18]

- Ashford's housing stock in 2001 was 42,920 this expanded to 46,270 in 2006 and is estimated to be 68,970 by 2026.[19]

As such, housing investment does therefore not need to be co-ordinated and leveraged from a central position. The initial investment would facilitate and allow for circumstances where local authorities are provided with an increased number of opportunities and abilities to negotiate with developers to improve local communities according to their specific requirements.

The inclusion of SME schemes within a State Investment Bank

A number of international State Investment Banks have SME specific schemes, such as The Brazilian Development Bank (BNDES), The European Investment Bank (EIB) and Kreditanstalt Fur Wiederaufbau (KfW) in Germany. This suggests that a State Investment Bank could operate in both facilitating large scale infrastructure investment and in aiding SME finance.

For example, KfW business area (Mittelstandsbank) for start-up and SME financing in 2011 is shown to have lent 22.4bn out of KfW overall activity of 70.4bn[20].

Another example is the European Investment Bank, which provides microfinance using direct and intermediated loans, through private equity and debt participations in intermediaries, and through direct and counter guarantee schemes.

EIB is either "a direct investor in or lender to microfinance institutions or indirectly finance [multilateral financial institutions] MFIs through specialised intermediaries, such as Microfinance Investment Vehicles (MIVs) or Microfinance holding groups.[21]"

These vehicles attempt to address the Macmillan Gap, which was identified in 1931. This gap exists because as small businesses grow there is a point at which personal savings are no longer adequate to fund expansion or investment. However, whilst growth may still be possible it is not yet sufficient to be of interest to institutional investors. Thus creating a gap where reasonably priced funding is difficult to obtain.

Estimates vary but this gap is estimated to be between approximately £250,000 and £1 million[22].

Both the Labour and current coalition Government have recognised the difficulties SMEs face with regards to accessing finance following the financial crisis. The government's role in the creation and easing of liquidity in this area as a prerequisite to generating economic growth is becoming increasingly important. For example, the Federation of Small Businesses (FSB) estimates that SMEs account for 58.8% of private sector employment and 48.8% of private sector turnover, employing in total an estimated 13.8 million people with an estimated combined annual turnover of £1,500 billion[23].

The importance of SME's to the economy is why a number of government policies such as the National Loan Guarantee Scheme (NLGS) have been, put in place to encourage liquidity in this sector. Another area currently under development is that of the British Business Bank announced by the Business Secretary at the Liberal Democrats Party Conference.

However, whilst this and previous scheme are positive steps, and despite Governments' efforts, to date there are limited signs of improvement.

For example, whilst there was a positive sentiment in business confidence between Q3 2009 to Q3 2011, (moving from its previous negative position during Q4 2007 – Q2 2009) this has since deteriorated. In 2012 businesses indicted a negative sentiment towards overall confidence Q1 and Q3, with Q2 being positive.[24] This demonstrates how businesses prefer a cautious outlook with regards to future economic conditions.

Part of the issue with schemes to date is that they can be complex in nature and rely on banks' participation. There are several issues which can result from this including; government's ability to judge the scheme's effectiveness; ensuring that scheme funds are lent to the intended participants; increased red tape; and the lag between announcement, implementation and actual lending. This complex series of interactions has also been highlighted by other research as being an issue.

This issue has been recognised by all parties, with Labour exploring the implementation of a State Investment Bank, and the Government, a Business Bank.

Whatever institution is formed, its ability to address wider financing issues, facilitate growth, address the Macmillan Gap and boost confidence for SMEs will all be key to its success.

How could an institution to address SME lending be structured?

Whilst both the issues surrounding infrastructure investment and SME's access to finance are important and should be tackled, there remain a number of concerns surrounding the fit of the two financing requirements if combined within the same body. These roles therefore require different teams with different skills, different support mechanisms and approaches, and varying degrees of intervention.

- "Each of the two areas will require very different skills, so it is likely that the BIB would effectively be two banks – a British Infrastructure Bank and a British SME Bank – under one banner.[25]"

For example, infrastructure investment requires the raising of significant capital, over a long period leveraging significantly on equity and debt investors. Following this, arrangements and regulatory environments need to be in place to provide funding for the service and provide a return to the investor.

Whereas, the financing gap for SMEs is by comparison small scale lending with niche risks and is also likely to be over a significantly shorter period.

In addition, by combining the two roles within a single entity there is a real risk that investors within the market will perceive the body as being ineffective at both tasks, lacking the specialism to deal with the specific issues and so lose confidence. This confidence is important.

IPPR recently further developed the debate surrounding some of the benefits of how a State Investment Bank which had a remit for both infrastructure and SME finance could be undertaken by a single overarching institution. Benefits included:

- The institution could help to facilitate the use and expertise of SME's in infrastructure projects.

- The model has already been demonstrated abroad suggesting the two items can operate alongside each other.

- The two remits would create diversity in the BIB's portfolio, allowing it to hedge risk and ultimately lowering the cost of finance.

Whilst these points are important, there are a number of factors which suggest that the need for both areas to operate within a single entity is not necessary to produce the above results.

For example, incentivising SME involvement in infrastructure should be based on the skills required to deliver a project efficiently with costs minimised. As such SME involvement should be incentivised as part of the procurement and delivery stage of infrastructure investment. A State Investment Bank's expertise would be in financing and so its expertise in incentivising this behaviour is likely to be limited.

Given that SME's are not homogeneous (eg. size, expertise, location, financing requirement all vary), Government policies need to reflect this variation within schemes. When considering the practicalities of an institution for SME financing, Government can tailor its expertise, to best leverage on areas where SMEs struggle. Alongside this, any additional services outside of the institution's remit need to be tailored to account for its presence in the market. The aim should be to provide a comprehensive set of policies that best enable SMEs to grow.

The other area of benefit concerns portfolio diversity. Whilst diversity can reduce risk, and it is probable that the SME financing function of a State Investment Bank may have a higher default rate this is by no means certain. For example IPPR note that:

- "Lending to small businesses will be inherently riskier than lending for infrastructure purposes, but there is no good reason to believe the loan default of a BIB would be high. The evidence from overseas state banks, including those like the KfW and BNDES that have large portfolios of loans to small companies, is that this need not be the case. Clearly this will depend, in part, on the nature of the portfolio of loans that the BIB accumulates."

BNDES for example have only 0.15% of non-performing loans compared to an average of 6% for commercial banks[26].

Whilst there are examples of where the two remits have been combined in a single entity internationally, such operations could also be undertaken by separate entities. Given the evidence regarding default rates from other international institutions, it does suggest that an SME portfolio can be managed effectively separately.

Another key potential problem of combining infrastructure and SME financing into one institution is it would be unfortunate if over time the two roles of the entity compete. Eventually one is likely to fall foul of the other scheme, given they are both very separate and important issues. Separate institutions would also ensure that the primary focus and goal of the institution remains solid throughout its investments.

The IPPR provides an example of such an occurrence in the past with the formation and eventual closure of the Industrial and Commercial Finance Corporation (ICFC). This institution was set up after the Second World War to help address the Macmillian Gap. However, over time, pressures to make higher returns on finance resulted in it the institution moving away from its original purpose, with its eventual closure.

As such, commercial pressures will build on the poorer performing activity, encouraging activity to shift, whilst also increasing the likelihood of political pressure to abolish, or artificially influence the poorly performing area. Such political interference would detract from the State Investment Banks key mandate of investment based on sustainable financial principles.

BNDES is presented as one of the examples used when considering how a State Investment Bank could perform both infrastructure and SME lending operations. According to its latest statistics the total number of funding operations was 896,000, an increase of 47% compared to 2010. The increase is in part due to the Bank's policy of expanding access to the Bank's credit, particularly for micro, small and medium enterprises to help counter the effects of the global economic slowdown.

However, BNDES disburses approximately 72.3% of all business loans made in Brazil with a maturity of three years or more.[27] This degree of intervention could be considered to have potentially gone further than just providing additionality given market failure. Given state aid rules such intervention would not be possible in the UK. Alongside this, a State Investment Bank in the UK would be operating in a mature financial market.

Separate entities would also allow for resources such as the Post Office to quickly and effectively provide one to one service. This would make deployment quicker and encourage local growth.

For example, the Post Office currently has more branches that the four biggest high street banks combined, thus allowing for wide spread dissemination. It currently provides its own banking services, and allows businesses and personal account holders to deposit and withdraw funds from partner banks. The latest bank to joint this scheme (HSBC) was announced in September 2012[28] and as such currently allows 95% of all UK debit card holders to access their accounts at the post office.

Utilising an institution such as the Post Office would allow government to leverage on its existing interaction and relationship with businesses through its delivery and financial product offering. In addition, government influence in the Post Office could also help to address some of the concerns that current policy initiatives have had in successfully boosting lending through third parties such as commercial banks.

Whilst there have been proposals to create support schemes for SMEs, the entity will still have to assess risks and use credit ratings as a measure of risk assessment. As such, it is likely that the issue of high transaction costs will continue, acting as a disincentive to lending. Higher transaction costs are an issue which currently does not appear to have been solved, and will be key to a scheme being successful and providing value for money.

For example, in the report by Nick Tott on the case for a British Investment Bank,[29] Germany was as outlined a comparison for developing an institution for lending to small businesses. However, Germany has a greater number of medium sized companies, and so schemes such as those proposed have a greater chance of success because the cost to loan value ratio is more preferential. The

UK on the other hand has a large number of micro businesses which causes issues with scheme implementation costs. So whilst lessons can be taken from how Germany has implemented possible solutions to SME funding, the UK cannot simply replicate this if it wishes to be successful.

One area in which the government could look to focus more resources is that of peer to peer lending. Schemes such as RateSetter and Funding Circle have emerged due to the lack of finance available following the financial crisis and in general, appear to be able to drive down the time and cost of this transaction process. This is done both by reducing the administration required and by limiting the losses an individual can incur by allowing them to microfinance part of a loan. Thus reducing their exposure to a single risky entity.

In addition, there may also be alternative schemes that would not be suitable for the UK market. For the smaller sized companies, cash flow and not capital for investment is the main issue that constrains growth (such as hiring additional employees).

This has been the area where lending terms have tightened significantly as a result of the recession and financial crisis.

For example, the use of overdrafts is down by one-fifth in 2005-2008 (42.5%) compared to 2001-2004 (52.9%). Rejection rates for SME overdrafts have also increased over time with the figure rising to 10.9% between 2005-2008 compared to 4.2% in the 2005-2008 period. When looking at the distribution of bank loan rejections in 2005-8 it is found that 73.5% of all overdraft rejections in that period took place in 2007-2008.

This demonstrates that financing is not the only issue facing SMEs. If undertaken an activity such as providing overdraft top up guarantees (which could be charged at a small fee) government could relatively quickly and inexpensively unlock significant investment and growth.[30]

There has been a shift towards such an institution existing with the Business Secretary announcing at the Liberal Democrats Party Conference that the Government would create a British Business Bank. This institution would be capitalised with £1bn of public money, and would aim to leverage up to £10bn of SME lending using guarantees through existing high street banks. Further details of the exact operation of this bank are expected in the Autumn Statement.

However, given the extent of the legacy from the financial crisis, the difficulty previous schemes have faced in facilitating lending through commercial banks and the continued tight lending criteria, it remains to be seen if the scale of the institution will be large enough to affect significant change in SME finance market conditions.

Building a State Investment Bank

The creation of a State Investment Bank will take time and will be a complex undertaking. Its structure will have to account for the political agenda, public perceptions, economic conditions, government finance, state aid rules, competition regulation etc.

For example, to set up a State Investment Bank, the UK Government would need to gain approval from the European Commission under state aid rules. These rules are put in place to ensure that national governments don't provide uncompetitive subsidies to national industries. As such the European Commission would need assurances that a State Investment Bank was not simply be undercutting commercial banks, or unfairly subsidising specific activities.

State aid rules do make exceptions for areas where it is accepted that market failure occurs. One of these areas would be that of SME financing given its recognition as a longstanding issue.

Thus, again there could be a benefit from separating an SME focused institution from the wider infrastructure investment bank as it would potentially speed up the SME specific institution's implementation. This would also allow policy makers to focus in more detail on the more general market failures and investment failures within infrastructure for the State Investment Bank.

For infrastructure there are also a number of reasons why State Aid approval could be sought on the grounds of market failure.

For example, the lack of markets accounting for externalities and their inclusion within the current pricing mechanisms. The cost of the negative externalities of carbon emissions is not factored into the electricity price.

Another area of market failure is that of imperfect information. Without adequate information consumers are unable to judge effectively the merits of investments, such as insulating a property. This is an area which was highlighted as part of the rationale behind the Green Investment Bank seeking State Aid approval, as it would help to pull together information from a variety of its investments to provide accurate and transparent knowledge to potential investors and projects. However, beyond this a State Investment Bank could further develop the case for investments such as flood defenses.

Further to this there are also failures surrounding the transfer of technology and the additional risks and tightened availability of finance available to an early investor. Early investors generally have higher transaction costs, because when the risk profile of a project increases (such as early technolgoical development), so too does the cost of capital and the cost of due diligence. This therefore reduces the number of projects that are economically viable (withstanding significant technological improvements).

Given the financial crisis, and lower levels of business confidence, there is an increasing case to suggest that there is a significant failing currently within this sector when it comes to new, innovative or large scale financing.

Whilst setting up a State Investment Bank will be complex there are potentially three options which could be undertaken.

- The first is that such an entity could be set up as a new institution.
- The second is it could be created out of the Green Investment Bank (GIB)
- Third, is that government take the rather more ambitious step of using their undertaking in RBS to spin off, buy out or create such an entity using RBS's existing expertise.

Whichever route is undertaken, it is key that the manner in which the new entity operates is conducive to its ultimate goal of facilitating investment and long term growth. Whilst this goal sounds simplistic, pressures from both the political and economic cycles will exist to do otherwise. As such, the structure, operation and objectives of the institution need to be multidimensional, providing headline objectives that remain rigid; providing long term confidence, with more flexible short to medium term goals which can react to market conditions under a pre-determined framework.

In terms of how a State Investment Bank should operate, it is generally felt that the institution should be mandate-driven, with governmental or parliamentary involvement at the strategic level to outline long term objectives. This would ensure that the operational aspects of the State Investment Bank are free from political intervention, avoiding knee jerk reactions and thus damage to investor confidence.

This model would be very similar to that of other international equivalents (e.g. EIB, KfW). This familiarity of rules, procedures, models should help to provide the degree of political accountability required whilst also providing confidence to the public, investors and business.

In terms of the actual mandate, the main focus of most State Investment Banks includes the promotion of growth, employment potential, economic and social cohesion and environmental sustainability.

It is, however, important to note that a mandate such as the one above is quite wide, and so can limit the effect the institution will have in any single sector. As such, the emphasis of the institution needs to be on additionality and the provision of expertise and funding that could not be obtained on the open market at a rate which would make investment possible (which also improves that probability of state aid approval).

It is important that a State Investment Bank is not seen as a one stop shop fix for endemic investment problems. As the institution will still have to operate as part of wider political and economic policies, it is also important that aspects of government policy are also consistent. Failure to provide a wider stable policy framework is likely to limit the degree to which a State Investment Bank can leverage finances and ensure value for money.

This demonstrates that such an institution would not only need market participants' buy in, but also political backing to promote and create confidence in investment.

For example, if a State Investment Bank had been investing in solar research during 2011-12, confidence in its investments and its potential returns would have be significantly reduced by the snap decision to review the Feed in Tariff (FIT) scheme.

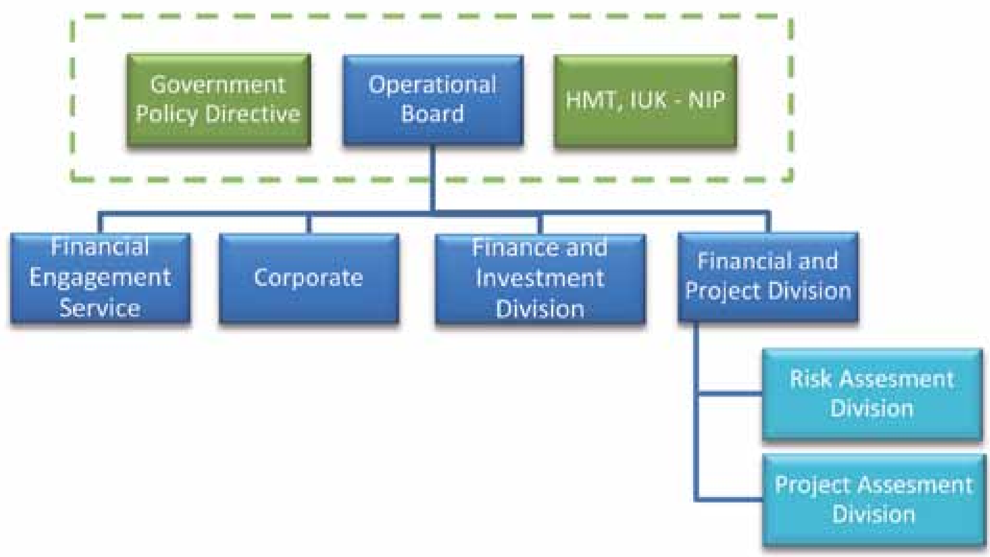
Whilst the establishment of a State Investment Bank, would not require cross party support, the success of its investments and continuing operations will depend on the support across the political spectrum. This is because it is vital that the institution has political backing, to bolster confidence in the institution and its role in long term investment.

The State Investment Bank's involvement in projects will mean that it has to be able to effectively assess and manage the financing, asses the risks involved in the construction and operations stages and look at the potential sale of the asset following completion.

There would also be significant benefit in such an institution providing financial advisory services. This would not only help to build their expertise but would also provide market participants with a resource to use if they needed to ascertain, find, promote or learn about attracting capital into their projects.

The other role of the bank would be that of leveraging capital from the private sector. This would require departments to assess financial risks and benefits, project specifications and project risks.

Such an arrangement would see the structure of the institution looking like:



The following would be undertaken as part of this structure:

- The Financial Engagement Service would be positioned within the State Investment Bank to prepare and help smooth the transition of companies/investors from that of enquiring about advice/investment to that of being able to access and apply for investment funds. Following the financial crisis and given the likelihood of changes to the regulatory regime, this department would be able to filter down the advice and guidance from the purely financial regulatory bodies to businesses. This would allow interested parties to understand how this is likely to affect their investment plans, and if there are any new additional requirements they must meet to ensure their best chance of ascertaining capital on the private market.

- The Finance and Investor Division would liaise with other potential investors and perform operations such as raising funds through bond issuance.

- The corporate section of the State Investment Bank would primarily deal with implementing the operational procedures as decided by the Operational Board given their mandate and political discussions.

- The Financial and Project Division of the State Investment Bank will be key. It is within this unit that projects are submitted, assessed and finance approved. Ensuring that a State Investment Bank has the necessary skills required to operate such a unit will be key to the operational success of the institution.

The institutional goals should be broadly similar to those of other investment banks. For example, KfW strategic mission statement is as follows:

- "We are the leading most experienced promotional bank in the world. We use our knowledge and our energy to improve economic, social and ecological living conditions.[31]"

Importantly, part of the bank's mandate must be the ability to be able to make a profit. This provides it with the means and credibility to interact with the public sector. In addition, it ensures it operates in a way that is not only fiscally responsible, but also has direct benefits in ensuring its long term stability of reserves and financing.

Whilst profit is important, it is also not the primary goal of this institution. As such, its remit should not focus on profit maximisation. For example, EIB's Annual report for 2010[32] it states:

- "The Bank's primary objective is not the maximisation of profit. Its Statute stipulates that interest on loans "shall be calculated in such a way that the income therefrom shall enable the Bank to meet its obligations, to cover its expenses and risks and to build up a reserve fund…"

Raising finance

This raises the issue of how the bank raises finance, what it can provide in terms of funding and how to achieve a credit worthiness that will ensure that it has a long term low cost borrowing rate.

Most financing for projects occurs via three methods: bank loans, bonds or equity. A State Investment Bank would need to be able to access all of these avenues. To ensure the State Investment Bank has a low borrowing cost, governments generally put in place guarantees or capital to provide market with the confidence that the institutions borrowing commitments are covered and risks reduced. For example, it is the government's financial backing that will provide the Green Investment Bank with its solid credit rating.

There are also certain restrictions that can be placed on the investment bank's lending criteria, such as the bank will not provide any more than 50% of the capital for a project. This limits its exposure, whilst providing finance and confidence and also reducing the chance of possible crowding out. For example, this condition is used as part of the EIB project finance scheme.

This paper will explore a number of ways in which a State Investment Bank could raise finance. However, a more detailed outline of a product offerings would need to be developed to provide confidence to investors if a State Investment Bank was to be put into place. This product development timeline would eventually sit alongside the State Investment Bank's development timeline and its future project investment plans.

Bonds

One of the issues that have been reported as part of the PFI review is that of getting pension funds and traditionally low risk profile investors into the earlier stages of investment. ACE's previous papers in the infrastructure investment series have explored several methods where this could possibly be achieved. A State Investment Bank could also play a role in attracting such finance, for example as the centralised body.

A State Investment Bank with a larger remit would also be able to issue bonds at varying maturities larger than that of single projects. This could be done across multiple sectors to achieve a variety of financial products that would suit a wide variety of investors.

For example, bonds could be issued for types of renewable technology (wind, onshore and/or offshore) or they could be based on the performance of a wider variety of projects in a sector (renewables, water, waste).

- For example, the Wind Prospect Group in 2011 launched a corporate bond, with the aim of raising £10m. The bond called 'ReBonds' pay a fixed return of 7.5% over a 4 year initial investment period, with a higher rate for larger investments.[33]

Bonds could also be issued based on the bank's entire portfolio. Each of these would have a different level of risk, and therefore a different return. The maturity of these bonds could then also be mated to this risk vs return environment to suit investors. For example, currently a lower risk, 5 year period bond with a stable return would be very attractive to the financial market given the troubles that have been experienced in the Eurozone area.

Loans

Another source of finance will be for the bank to provide loans directly, or to use its funds to leverage further funding via private bank loans.

It is important that a State Investment Bank provides loans on a sound basis, earning income off future repayments, which enable it to reinvest and further fund projects.

Where a State Investment Bank would benefit is that it does not need to make the returns that are required by commercial institutions and investors. As such, a number of projects that were viewed as unviable and potentially risky in terms of ensuring a reasonable return may be considered as acceptable. For example, projects such as early installations of deep offshore wind generation may provide a return but not at a rate the market deems suitable given the risks involved of being an early adopter.

The bank can therefore undertake projects whereby the returns are smaller but the positive externalities and benefits of investment are significant.

Another role the State Investment Bank would be involved in is that of leveraging finance from commercial institutions. By providing a degree of the funding and negotiating terms with private investors, the State Investment Bank should be able to achieve syndicated loans that carry less risk and lower borrowing cost given its involvement.

Grants

On some occasions where public goods are deemed to be of significant public interest, and there is no perceivable market, the State Investment Bank could provide grants to certain projects. This utilises their investment expertise and resources to aid more traditional public funding.

These grants could be conditional on the investment encouraging or engaging further private investment given the State Investment Bank's initial involvement. An example of this could be the provision of flood defences in an area. Where suitable, the initial investment in an area could help to secure future development. This is because it subsequently encourages further investment in roads, rail housing etc. due to the improvement in conditions as a result of the initial investment.

'Top Up' guarantee

A State Investment Bank may not always need to physically invest in a project to ensure investment. The government could conceivably create a £5bn leverage fund.

This fund would be used by the State Investment Bank following the identification of suitable projects to 'secure' what is perceived as the required rate of return within the private sector if returns fall short of expectations.

This fund would not contribute to the return of the project for the private investor if a predetermined rate of return is ascertained or exceeded. This effectively sets a minimum rate of return, but also allows government to recycle funds if the 'top up' does not occur. As such, a £5bn fund should be able to leverage a far greater degree of investment than that of purely providing loans.

The key to the success of such a fund is in the ability of the State Investment Bank to judge what the market considers a reasonable rate of return and to ensure that the majority of projects are able without unreasonable or significant risk to attain this level of return (e.g. 7%). This should ensure that the fund does not become a public subsidy on projects with a low return.

This top up guarantee resembles the contracts for difference proposal in the Electricity Market Reform process and would differ slightly to the Government's current UK Guarantees scheme[34]. The UK Guarantees scheme aims to secure a proportion of the funding for a project where finance has fallen short due to tighter credit conditions. However, there is no reason why a State Investment Bank could not operate both schemes to create diversity in its product offering.

Building a skills base

For a State Investment Bank to be successful it must build an expert skills base to assess projects, risks and implement financial tools. If a State Investment Bank is to be constructed as a new institution this process will take time. However, there are some ways government could not only speed up this process but also ensure the future effectiveness of the organisation.

- The first is to use the existing skills base already employed as part of the Green Investment Bank as the basis for a wider State Investment Bank.
- Second, the government should explore how existing bodies such as the UK Export Finance and consider if they can play a wider role as part of the State Investment Bank.
- For example, UK Export Finance aids exporters by providing guarantees, and reducing the risk profile on projects. Whilst a UK State Investment Bank would be able to extend its product offering to include the financing of projects, it could utilise such expertise. If UK Export Finance's resources and expertise in both reducing risk and its links to international markets were utilised in a State Investment Bank it could become a powerful tool for investment. In addition, these skills could also expand the State Investment Bank's role to a wider facilitation of investment by aiding exporters in other countries. This would create a well-connected, international investment vehicle to promote UK investment, skills and expertise.

Regulating a State Investment Bank

Another area which needs exploring further is how the State Investment Bank will operate and integrate with the Financial Services Authority (FSA) and the Bank of England (BOE) under their new roles. It would be important that a State Investment Bank was seen to have the full backing of the BOE, FSA and Government to provide confidence to investors.

There may also be a role or a possibility of utilising the significant knowledge pool from the BOE to review and monitor investments. For example, the Office for Budget Responsibility (OBR) currently reviews fiscal spending. The OBR or the BOE could play a similar role in providing confidence in the assessments of the State Investment Bank.

If regulators were to play a role in ensuring and corroborating the State Investment Bank's activities, producing statistics on the probability that it is facilitating or crowding out private sector investment, this would provide significant transparency and confidence to the financial sector.

An independent review of such activities could provide a key tool in maintaining the public's confidence in the institution and its investments in terms of value for money, whilst also providing an independent check for the institution itself.

Capitalisation of the State Investment Bank

As has been demonstrated by the £3bn put in place to start the Green Investment Bank, a wider State Investment Bank would also require capitalisation.

Currently there are few estimates as to the scale that such a capitalisation would need to be. For example, IPPR estimates that £40bn of capital could be injected into a British Investment Bank over a four year period, leveraging private investment at a ratio of 2.5:1 resulting in the institution having a balance sheet of £140bn at the end of the period.

There are a number of estimates as to the scale of investment that the UK is planning to undertake, and its actual need to become internationally competitive. For example, the Government's National Infrastructure Plan[35] states that currently over £250 billion of investment in infrastructure is planned to 2015 and beyond. However, this compares to an estimated investment need of £434 billion by 2020[36]. As such, an additional £140bn from an institution such as a State Investment Bank would provide a significant degree of additional progress towards both the more conservative and larger estimates.

To put this figure in the context of the UK's national output, if we take the four year period 2008-2011, the UK's output equates to £5,726bn[37] if the State Investment Bank had been running over this period and leveraged the anticipated capital it would have equivalent to 2.4% of total output over the period.[38]

The CBI estimates[39] that public sector net investment of 2.25% GDP is required to maintain services in the long term whilst maximising growth and ensuring international competitiveness. As can be seen from this estimate whilst a State Investment Bank would not replace government investment it could contribute significantly to the UK's capital investment position, helping it to restore its long term investment profile.

The challenge is how such capital requirements would be financed given the challenging economic conditions and stretched public finances.

There are a number of methods through which capitalisation could occur:

The first is using public money to capitalise the bank, as has been done with the Green Investment Bank. However, to fund this approach, Government would be required to undertake one of the following.

- Raise taxation to generate funds. Recent figures from the Office of National Statistics on the public sector finances suggest that the sluggish nature of current economic growth is beginning to impact on tax receipts. As such, any further taxation rises may result in revenues falling as consumers' expectations and spending adjust, reducing growth further. This suggests that in the short term, given the economic climate, raising revenues from taxation will be difficult unless money is channelled from existing resources.

- An alternative would be to instigate further spending cuts with revenues directed towards capitalising the State Investment Bank. Whilst this theoretically should be simple, implementation is difficult. This has been demonstrated by the current spending cuts which are not having as big of an effect on the public finances as initially anticipated. Given this, and probable public opposition it will be difficult to capitalise the State Investment Bank via further spending cuts.

- The final option would be to capitalise the institution using government borrowing. This raises a number of concerns, such as, would this borrowing count towards the public debt and is this position sustainable given the current status of the public finances? However, assuming a credible plan was put in place, with the State Investment Bank earning profits from its investments there is no reason as to why this would result in a further deterioration of market confidence. In addition, current government borrowing rates are around historic lows, suggesting that the value for money Government could achieve per pound borrowed should be greater.

Another possibility is to capitalise the State Investment Bank through the sale of existing infrastructure assets. This method is also being utilised for the Green Investment Bank, with £2bn expected to be raised from the sale.

Whilst the £2bn at first seems significant in terms of its scale, the Department for Communities and Local Government (DCLG) in 2011 published the first list of assets owned by government. The asset map revealed that Government owns over 180,000 assets, through 600 public sector bodies, including Central Government and 87 councils[40]. These public sector assets are worth an estimated £385bn[41].

Another suggestion has been that any proceeds from the sale of the government's stakes in RBS and Lloyds could be used to capitalise the bank. This could occur in two ways, by reinvesting any profit from the sale or by reinvesting the original £65.7bn capital injection.

However, as is pointed out by the IPPR, the Government is currently sitting on a loss and so has no profit to invest, and if the original stake were to be channelled into a State Investment Bank then this 'one off' intervention in the financial sector would become general government borrowing and so be included in the targeted measure of public debt.

Another option Government could potentially explore is the use of the Bank of England (BOE) and Quantitative Easing (QE) to capitalise the institution.

To do this directly the State Investment Bank would need to issue bonds that could be purchased by the BOE.

Unlike the current implementation for quantitative easing which has focused on the recapitalisation of the financial market, with little subsequent increase in lending. The State Investment Bank would be obliged to invest the funds into projects which are more likely to have an effect on the real economy, improving jobs and growth in the areas of investment.

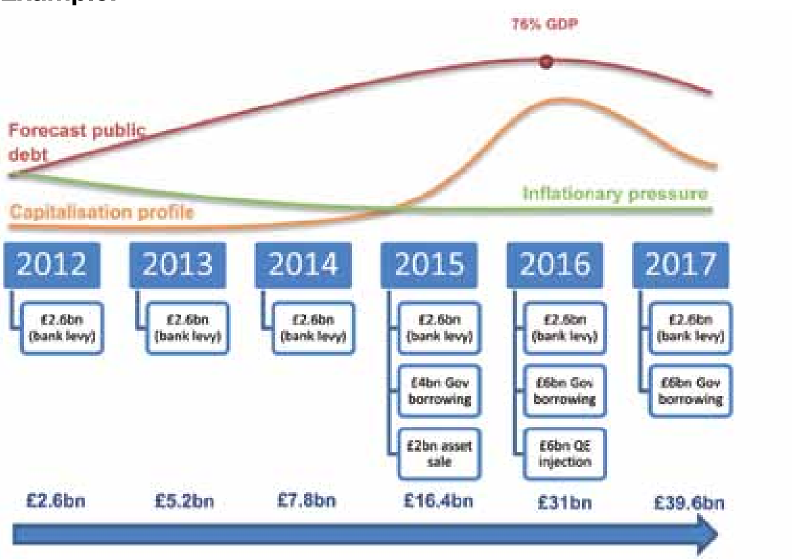
However, such use of quantitative easing has not been undertaken in the UK before and would need further exploration. For example, there has been criticism that the current round of QE has helped to artificially maintain higher commodity prices. The scale of such a scheme would need to be explored as would the possible unintended consequences. Inflationary risks would also have to be assessed fully before such measures are undertaken.

Other suggestions include using the funds from the banking levy to help capitalise the State Investment Bank. The levy in 2012 is estimated to raise £2.6bn, if each year's levy was put towards a State Investment Bank by 2017 the Government would have built up £15.6bn in capital for investment. Given leverage ratio of 1:2.5 the government could leverage 39bn which alongside its original investment would secure investment of £54.6bn of funds for investment into infrastructure. Such investment would be seen as a positive outcome given the support taxpayers provided during the financial crisis.

Given the constraint on public finances and that all the solutions above have advantages and disadvantages, the government, if it were to set up a State Investment Bank, would have to provide confidence to the market.

This confidence will come from Government ensuring it has a number of reliable funding streams to capitalise the bank and ensure future investments. Using multiple capitalisation mechanisms reduces the political risk in any one area, whilst a credible plan also provides the confidence that government backs the investment stream.

Example:



As can be seen from the diagram, by combining a number of revenue streams the Government can build a significant pool of capital for a State Investment Bank. Within this it can account for its public debt profile/forecasts, inflationary pressures, economic growth expectations and importantly, build market confidence in the institution's future pipeline and project delivery schedule.

One of the most debated issues surrounding a State Investment Bank is whether its investments should be on or off of the Government's balance sheet. The schedule in this paper suggests that a combination of the Bank levy, limited government borrowing and some degree of asset sales could capitalise the State Investment Bank.

Given the capital base for the State Investment Bank would be built using Government finances it would be inappropriate for these not to appear on the government balance sheet.

However, within this there is the need to provide market confidence that the UK and the Bank itself are not borrowing beyond their means, and that the State Investment Bank will ultimately make a return. For this reason a full operational balance sheet for the State Investment Bank must remain independently auditable from that of general government expenditure, with both its overall assets and liabilities included within future Government finance figures. The schedule proposed in this paper also recognises the need for confidence, given the scale of current public borrowing requirements. As such, it suggests that capitalisation of the State Investment Bank occurs over a number of years, increasing as the UK moves towards 2016 when the pressures from the UK deficit is significantly reduced.

This should therefore help to ensures that liabilities and investments are tracked and benchmarked against their returns, ensuring investor, public and government confidence in the State Investment Bank and its long term returns.

This schedule would align with the National Infrastructure Plan to further build confidence and delivery. This over time should boost the UK's international competitiveness and improve its economic growth prospects.

Implementation possibilities for a State Investment Bank

There are a number of ways in which the formation and implementation of a State Investment Bank could occur. These include:

- Build the entity from scratch as a new institution
- Developing a State Investment Bank out of an existing entity such as RBS or the GIB.

Both of the above options will have their benefits and disadvantages, but it is important that these are debated openly and transparently to ensure that if a State Investment Bank were to be set up it is done so in the most efficient way possible.

Starting a new institution

This paper does not explore the possibility of creating a State Investment Bank as a new institution. This is because the role it would undertake, the licences it would have to obtain, and the approval of state aid clearance would all take significant resources and have already been under taken as part of the formation of the Green Investment Bank.

As such, it is felt that this option is likely to result in excessive delays in implementation, and provide poor value for the taxpayer if such a process were to be repeated for a new institution when an existing one could have its remit expanded.

Developing a State Investment Bank out of an existing institution

Scaling down RBS

The financial crisis whilst posing a significant number of challenges for Government may have also provided an opportunity, which would otherwise not have been considered in the formation to develop a State Investment Bank.

As the crisis took hold the UK Government was required to underwrite, and inject significant equity into a number of banks. The most significant of these was the RBS, with Government becoming the majority shareholder in November 2008. Including both ordinary and B share holdings the total economic ownership of RBS by the UK Government is currently 81.5% of the RBS Group.

UK Financial Investments Ltd (UKFI) which was formed by the Government to manage its investments in financial institutions, has a clear mandate to eventually dispose of the Government's shareholdings. This has to be done in a way that does not create instability within the financial sector, and must ensure competition within the sector.

To assess the practicality of this option below is an outline of RBS's structure as outlined on its website.

- UK Personal Banking - comprising of retail, corporate and commercial banking and wealth management services.
- UK Corporate Banking - Serving UK corporate and commercial customers from SMEs to UK based multi nationals.

- Direct Line Group - insurance arm which includes several well-known brands including Direct Line, Churchill and Privilege.
- US Retail & Commercial Banking - provides financial services through Citizens Financial Group.
- Ulster Bank - provision of financial services across the island of Ireland.
- Markets & International Banking - the investment banking arm of the group offers a broad range of services enabling major corporations and institutions to achieve their global financing, transaction services and risk management objectives.
- Wealth - offers banking and investment services to wealthy private and business customers in the UK and around the world. It covers RBS Coutts, Coutts & Company and Adam & Company.
- Business Services and Central functions - supporting functions include Business Services, Human Resources, Communications, Finance and Group Strategy
- Non-Core Division - ensures RBS is equipped to deal with the challenges facing our industry [the financial sector] and consists of Non-Core & Asset Protection Scheme, Global Restructuring Group, Group Risk and Group Legal & Secretariat.

The above suggests that it may be plausible to build a State Investment Bank for infrastructure out of RBS by transferring ownership to the state and selling off the unwanted divisions.

The Wealth and Markets & International Banking parts of RBS could be formulated into to a state backed infrastructure investment entity. There is also the possibility of SME financing which could be formed out of RBS's UK Corporate Banking service. However, there are a number of issues with this approach.

Firstly the Government whilst holding a significant number of shares in RBS has maintained that it does not wish to significantly influence the commercial and operation decisions taken within the bank. Within this there will be an underlying wish for taxpayers to make a return on the bailout funds committed to RBS as part of its bailout, at a cost of approximately £45bn.

This would mean that any entities that the state did not wish to be part of its new investment vehicle would have to be sold and potentially cover this cost for the State Investment Bank to be publically acceptable.

Whilst it is possible that significant sums could be raised if the government were to go down this route, nationalise and then sell off unwanted aspects of the bank, the sale of Northern Rock to Virgin has demonstrated how the UK Government would be at a disadvantage as it is currently a buyers' market, and finance conditions are not conducive to receiving the best price.

- For example, the sale of Northern Rock to Virgin Money was reported to have lost the taxpayer between £400m and £650m[42].

Secondly, there are competition rules with regards to state intervention into the financial market. It is therefore likely that if the UK were to use RBS for the formulation of its State Investment Bank, alongside the UK Government's current involvement in National Savings and Investments (NS&I) and Lloyds that there would be significant issues to resolve with regards to competition legislation on both a UK and EU level.

As such, building the State Investment Bank out of an entity such as RBS may prove to be too complex, time consuming and costly for the taxpayer.

Scaling up GIB

Another alternative is to take the Green Investment Bank and expand its remit going forward as it develops expertise.

Having gone through the process of gaining state aid approval, Government would be wise to use this institution as effectively as possible in a wider variety of sectors where market failure occurs.

This could be done by using the operation of the Green Investment Bank, and its current approval to smooth and possibly speed up the transition of the Green Investment Bank to that of a full State Investment Bank. However, whilst there will be some benefit in this approach it should also be noted that with a significantly widened remit it is likely that the institution would still need to seek a renewed approval given its expanded activities. This would therefore need building into any future development of a State Investment Bank.

One of the key aspects for market confidence is the provision of a clear roadmap. This should outline in a transparent manner policy objectives, investment areas, and funding changes.

For a State investment Bank to be successful the market requires confidence in its longevity. If this is not provided policy and funding uncertainty remains.

Whilst Government could start the process of forming a State Investment Bank from conception this would not be efficient given the work that has taken place in the establishment of the Green Investment Bank it would be far better to outline a clear path of evolution into a fully functioning State Investment Bank over a ten year period.

For example, if we take a number of possible developments, this roadmap outline would look like this:

2012
Establishment of Green Investment Bank – capitalisation £3bn

2014-15
Green Investment Bank given facility to borrow.

2014-15
Target investments set for a five, 10 and 25 year period in each sector reported.

2016
The Green Investment Bank begins to shift its 'green' agenda to one of sustainability this should encompasses all aspects such as use of resources, future proofing, emissions, international competitiveness etc. Application for State

Aid approval for full State Investment Bank operations in preparation for 2017.

2017
The Green Investment Bank remit is to be expanded to that of wider infrastructure projects, forming a State Investment Bank. This would occur on a sector by sector basis building skills in the relevant areas with regards to financing, returns and project risks. Projects in these new fields are funded by the capitalisation proposed earlier in this report, with borrowing not permitted in these new areas, limiting risk while allowing skills to build.

2018
Target investments updated.

2019
The State Investment Bank is allowed to borrow against all areas of its operations, providing loans for projects.

2020
Explore the possibility of the State Investment Bank's remit being expanded to include implementation of the National Infrastructure Plan. This would provide both political and market certainty over the delivery of infrastructure linking policy closer with delivery, funding and efficiency.

As can be seen from the above scenario this general development over time means that the institution is grounded in its funding streams, develops the skills required to operate in a tricky section of the market and provides forward confidence to investors as to where the institution will have an interest.

Moving forward

This report has explored the current thinking surrounding the idea of a State Investment Bank, and some of the possible challenges with implementation and remit.

If a government was to take forward the implementation of a State Investment Bank this report has identified a number of areas which would help to improve market confidence.

- The first is that the structure of a State Investment Bank should be based on successful international examples such as those mentioned in this report. In this respect, operations of the bank should be free from political interference, whilst the bank's overall remit is provided by the government.

- The bank's remit should focus on long term growth and performance. Allowing the institution to invest and re-invest returns. As such, it is vital that the State Investment Bank is not seen as a short term stimulus to economic growth.

- For a State Investment Bank to be effective, a future government should undertake a detailed analysis and assessment of its existing policy framework in light of the new institution's position and influence in long term investment decisions. This is not only important for market confidence but ensures that the State Investment Bank is able to assess projects and their returns based on stable policies reducing risk and improving the chance or stable returns.

- If a government were to undertake the task of building a State Investment Bank a clear and credible capitalisation plan would be key to market and investor confidence as well as ensuring that the State Investment Bank achieves the highest possible credit rating.

- Finally, a roadmap should be put in place at the earliest possible stage outlining the evolution of the State Investment Bank. This provides investors with a clear timescale as to when they can expect funding streams to be put in place within various sectors. It also would allow the relevant industries to gear up their skills and delivery mechanisms to ensure projects were delivered as efficiently as possible.

End notes

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ACE economic and policy papers

This paper forms part of a growing portfolio of research by ACE into the effects of infrastructure on the wider economy. The papers below outline the case for funding, a variety of funding methods including traditional and new forms of infrastructure spending stimuli, and more detailed sector specific issues such as retrofitting and microgeneration.

Green Investment Bank
This paper is the fifth in ACE's infrastructure investment series and explores in more detail the rationale behind the Green Investment Bank and the challenges it faces going forward given market conditions in 2012.

Pensions and infrastructure
This paper is the fourth in ACE's infrastructure investment series and explores in more detail the current conditions within the market, and the implications they have on pension funds' investment potential into infrastructure.

Procurement in PPFM
This paper is the third in ACE's infrastructure series and examines how to improve procurement in Public Private Finance Models (PPFM)

Public Private Finance Models
This is the second in ACE's infrastructure series and explores in more detail the rationale, performance and conditions that surround Public Private Finance Models (PPFM)

Performance of PFI
This paper is the first in ACE's latest infrastructure series and reviews the performance of historical PFI data to learn lessons for the development of new financing models

The 2012 budget
ACE's analysis - A comprehensive analysis of the 2012 budget, the economic and fiscal outlook from the Office for Budget Responsibility and the Infrastructure Delivery Update

Budget submission 2012
Budget submission to HM Treasury for 2012

ACE reports on detail of Autumn Statement
A full analysis of the Chancellor of the Exchequer's Autumn Statement, the updated National Infrastructure Plan and the Office of Budgetary Responsibility report on the economy.

Barriers to Investment
Explores a wide variety of aspects that act as barriers, or significantly change the risk profile of an investment project. These processes are important within the investment cycle and should be understood by all parties involved

Infrastructure: A case for funding
This report reviews and analyse a range of material that is openly available to ascertain what effect infrastructure investment has on the economy.

The Infrastructure Investment Trust
ACE proposes a supplementary model to PFI initiatives, to read the executive summary please click here

Retrofitting the UK's housing stock
This paper is intended as a conversation starter on how retrofitting might be taken forward in the residential sector

Department for Infrastructure
ACE makes the case for a new department to support government and infrastructure

Spending efficiency
This paper makes the case for a balanced scorecard approach to achieving efficiency

Infrastructure funding
a range of options in its latest policy paper: Infrastructure Funding.

About ACE

ACE represents the business interests of the professional service providers in the built and natural environment in the UK. ACE is the leading business association in the sector, with around 600 firms employing 90,000 staff – large and small, operating across many different disciplines – as its members.

Those members are some of the world's leading consultancy and engineering businesses. Renowned for the quality and excellence of their work, they regularly win awards for engineering innovation and achievement.

ACE's powerful representation and lobbying to government, major clients, the media and other key stakeholders, enables it to promote the critical contribution that engineers and consultants make to the nation's developing infrastructure.

ACE's publications, market intelligence, events and networking, business guidance and personal contact, we provide a cohesive approach and direction for our members and the wider industry. In recognising the dynamics of our industry, we support and encourage our members in all aspects of their business, helping them to optimise performance and embrace opportunity.

Our fundamental purposes are to promote the worth of our industry and to give voice to our members. We do so with passion and vision, support and commitment, integrity and professionalism.

Further information
For further details about this publication
please contact the author:
Graham Pontin
Senior Economic Analyst
0207 227 1882
gpontin@acenet.co.uk
www.acenet.co.uk

consultancy engineering business environment

Association for Consultancy and Engineering
Alliance House, 12 Caxton Street, London
SW1H 0QL
T: 020 7222 6557
F: 020 7990 9202
consult@acenet.co.uk
www.acenet.co.uk