

# Blueprint for a British Investment Bank

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The Office of National Statistics recently reported that the British economy has grown by only 0.5% over the past year: private sector demand is depressed by deleveraging and uncertainty, while public sector demand is constrained by the government's austerity strategy. Britain needs to rebalance its economy away from reliance on credit-fuelled private consumption and towards investment and exports. And the public has lost confidence in banking as a socially useful activity.

A British Investment Bank (BIB) presents a potential solution to these problems. Robert Skidelsky at the Centre for Global Studies and Felix Martin at Thames River Capital invited leading figures from the British private and public sectors, as well as representatives of the European and Nordic Investment Banks, to discuss the merits of this solution at a one day conference in Westminster on the 2 November 2011. This publication is inspired by these discussions.



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# Introduction to the British Investment Bank Conference

Thank you for making the time to come to this colloquium on a British Investment Bank (BIB). This is a good time to hold such a conference. It is clear that national recovery has stalled. The British economy has grown less than 1% in the last 12 months. National income per head – the only measure which matters for the British people – has actually fallen. Given this dismal situation, it is hardly surprising that more and more people have been asking: where is growth to come from? The Government is committed to removing 2% of GDP a year from the economy over the course of this parliament. The Bank of England has just announced a new £75bn round of quantitative easing, but even the Governor, Mervyn King, does not believe that this modest programme will be able to kick start growth. At most, and subject to many uncertainties, it may do something to offset GDP decline. Not the least frightening fact about the Bank of England's latest assessment of the effects of QE is that the Bank does not actually know how money created by the Bank is transmitted to the economy.

We may expect some relief from the exchange rate. But our major trade partners in Europe and elsewhere are not growing either. It is in this context that what I call Plan C - Plan A being the now exploded theory of 'expansionary fiscal contraction' and Plan B being a further bout of QE – becomes relevant. Quite simply, we need to develop a credible growth strategy. This need seems to be realised by the Treasury, hence the Chancellor's hints of a '£50 billion investment boost'.

One such strategy would be to create a British Investment Bank. The first session will look at the rationale for such an institution. This is not, of course, a new idea, but the current economic situation has given it a renewed urgency. A British Investment Bank could achieve two goals simultaneously: it could improve the long-term growth prospects of the British

economy and at the same time offset the contractionary effects of fiscal consolidation on aggregate demand. Some would concede that such an institution would fill a gap in the capital market but deny that it could do anything to boost demand in the short-term. My own view is that there is no contradiction between the two arguments. Of course, it will take time to get the long-term investment programme going. But a substantial start can be made over the next five years, providing the will to accelerate is there. And one should not underestimate the effect on confidence of a simple announcement of an expansionary programme.

To turn to today's position: the government is constantly exhorting the banks to increase their lending – even as it proposes to burden them with increased capital requirements. The truth is that the banking sector is paralysed by a lack of confidence, which means that sound investments go unfunded while bank reserves pile up. Banks are busy repairing their balance sheets, and borrowers cannot overcome the barrier of the high interest rates which result. Bank loan approvals to SMEs have fallen by over a quarter since 2007, and the stock of lending has shrunk by £5bn over the last year. A BIB could, as much by example as by action, help clear the blockage in the financial system.

Apart from the short term problem of demand deficiency, there are at least three gaps which the private sector is seemingly unable to fill on its own: first, the 'Macmillan' gap, a funding problem for SMEs, first identified in the 1930s; second, the deficiency of investment in infrastructure. According to the Institute of Directors it will require £500bn over the next decade to rectify the infrastructure gap. Finally, there is 'green investment'. A Green Bank with a promised capital of £3bn already exists. But it is not yet operational, and it will not be allowed to borrow until the government's deficit is liquidated. But it could be the nucleus of something more ambitious.

The second session will deal with the theory and practice of national development banks, using examples from abroad. We

need to tackle head on the common Anglo-American view that 'government can't pick winners'. The quick answer is that governments can pick winners, and the private sector can pick losers. State investment banks have been successful elsewhere (and in fact in the past, in the UK), and we can learn from these experiences. Take, as one example, Germany's KfW, which has nurtured the German Mittelstand of companies since the late 1940s without additional injections of capital. Or the European and Nordic Investment Banks, from whom we will hear. The theory that capital allocation should always be left to the markets is valid only under ideal conditions. In the world of second bests we must compare what publicly-directed investment might do with what the private capital market actually achieves.

In fact, the financial sector has repeatedly demonstrated a crippling short-termism. There is evidence that the time horizon of investment has become ever shorter. It is now increasingly difficult to distinguish between investment and speculation. A national investment bank that took investment decisions on long views and on the basis of the general social advantage would be a strong corrective to the relentless concentration on maximising short-term shareholder value.

Our final session will consider the practicalities of a British Investment Bank. If the idea is to be taken seriously, we must think about how to mobilise investment without adding to the deficit. We can take it as a given that the government will not break its own fiscal rules. So how will the BIB finances relate to the public finances? Here we can look at the various models which operate around the world. Will we need a new institution? The government already owns banks. Could these be re-purposed to public ends? Perhaps the most basic question – what will it invest in? And how can we make it an attractive alternative to bonds for institutional investors? Overcoming the private sector's preference for liquidity, their reluctance to invest in anything which carries a greater risk than gilts, will be a key aim. To whom will the BIB be accountable, and how will it be governed? What planning hurdles might potential

investments face? These are the key practical questions which need to be resolved.

In conclusion, let me emphasise one thing: the British Investment Bank is one of a number of possible vehicles to reignite growth. It can be run in conjunction with other policies, and other institutions. The overriding aim is to develop a growth strategy, not to insist dogmatically that there is only one way to do it.

Robert Skidelsky

London

2 November 2011

# Rationale for a British Investment Bank

A mismatch between private financial returns and social economic returns has resulted in a lack of funding for projects of long-term value to the economy. Sectors particularly affected include R&D, communication and utilities networks, 'greening', and transport infrastructure where the risks typically associated with the scale and time horizon of these projects as well the inability of private investors to internalise fully the returns of their investments lead to suboptimal levels of output.

But not only large investment projects suffer from market failures; being too small is also a problem. The difficulty for small and medium-sized enterprises (SMEs) to obtain funding was officially recognised in 1931 with the identification of the 'Macmillan Gap'. Currently, the gap is located between approximately £250,000 where personal savings and seed money no longer are enough and £1 million where institutional investors become interested. Lack of economies of scale in the administration of loans to SMEs and start-ups is a primary reason for banks' lack of interest in lending to smaller actors. These are instances of supply-side failures: socially profitable projects are not supplied with the necessary credit to take off.

The present crisis has added to this problem in two ways. First, pressure on commercial banks to repair their balance sheets in combination with heightened levels of uncertainty has reduced bank lending even to projects which previously did not suffer from credit-supply problems. But more importantly, the crisis has brought about a chronic shortage of private sector

confidence. This is a demand-side problem. Households' and companies' gloomy views of the future have killed demand for investments even at very low capital costs since the yield prospects of investments are deemed to be too low. This has in turned resulted in a collapse of consumption as households struggle to rebuild their net worth in the face of diminished asset bases, which has led to less spending, more job cuts, less demand and, therefore, to a further deterioration in confidence.

Conventionally, both supply-side market failures and insufficient private demand are arguments for government intervention. By committing public funds to universities and infrastructure the government overcomes the shortage of funding for such projects; by giving tax credits and loan guarantees to SMEs the government reduces the failures of the credit markets for SMEs; and in both cases, increased economic activity increases aggregate demand which in turn boosts private-sector confidence. However, the current Government's political commitment to fiscal contraction has effectively ruled out any such stimulus of the economy.

Establishing a British Investment Bank (BIB) offers an innovative solution to both (1) long-term failures in the supply of credit and (2) the more short-term lack of aggregate demand. Given the appropriate institutional structure and mandate (discussed below), the BIB could contribute to infrastructure and R&D investments as well as SME growth by providing attractive finance on the basis of social economic returns in addition to more narrowly construed private financial returns. By providing policy stability, signalling confidence in the project and serving as a focal point for project preparation activity the Bank would stimulate demand amongst potential private infrastructure sponsors. The Bank's objective in SME finance would be to improve the intermediation of private sector savings to SMEs via the capital markets – for example by co-ordinating the securitisation of SME loans – as well as via commercial bank lending – for example via guarantees. And it could do so with minimal impact on public finances by borrowing money from the private sector against a limited

public subscription capital – thus reducing the political cost of increasing effective demand.

The short and long-term rationales for a national investment bank should not be considered in isolation. In both theory and practice, the two functions are closely interlinked. In theory, it is possible to argue that deflated aggregate demand is the consequence of a decades-long trend of growing income inequality which has resulted in a structural lack of mass consumption power. Solutions to the ‘short-term’ problem, therefore, must be compatible with a long-term objective of reversing inequality. In practice, the Bank will need to leverage its long-term credibility to offer short-term ‘additionalities’ and attract private capital.

In summary: there is a twofold rationale for a national investment bank:

1. In the short term it would boost aggregate demand
2. In the long term it would contribute to the structural reform of the UK economy

# Contemporary Examples of Public Investment Banks

The idea of a public investment bank is not new. After the Second World War, a number of multilateral and national development banks were founded. Multilateral investment banks included the World Bank, the European Investment Bank, the Nordic Investment Bank, the European Bank for Reconstruction and Development, and the Asian Development Bank. National investment banks included Germany's KfW, the Japanese Development Bank, the Korean Development Bank, and the BNDES of Brazil. Common to most of them was a return to an investment bank model prevailing in Germany in the late 19th century: offer long term credit and provide technical assistance – sometimes in exchange for an equity stake in the project supported.

Together with the KfW, the Nordic Investment Bank (NIB) and the European Investment Bank (EIB) are the most relevant benchmarks for how a British Investment Bank could operate. It is therefore helpful to study these examples before sketching institutional and operational outlines in a British context.

## **The Nordic Investment Bank**

### *Background and mandate*

The Nordic Investment Bank (NIB) was set up in 1975 by the five Nordic countries: Sweden, Norway, Denmark, Iceland and Finland. In 2005, the group was joined by the three Baltic states: Estonia, Latvia and Lithuania. The idea was to set up an institution which could promote the integration of the Nordic

economies which at the time were separated by tight regulation of capital markets and the need for authority approval on cross-border transactions. Simultaneously, the Nordic economies were suffering from the oil crisis and there was a general perception that the countries would benefit from an institution with strong credit worthiness with which to access international capital markets more cheaply.

While the NIB's mandate has changed since its founding, the overall setup of the Bank as a mandate-driven institution has not. In other words, the objective of the institution is to optimise its mandate delivery and not necessarily to maximise the financial yield on its assets. Today the mandate is twofold:

1. To promote the competitiveness of the member state economies
2. To promote a better natural environment

#### *Bank structure*

The institutional structure of the NIB conforms to the design of a number of multilateral investment and development banks. At the helm, the NIB is governed by the Board of Governors made up of the Finance Ministers of the member countries who typically meet once a year to discuss high-level policy aspects and approve the annual report. The Control Committee which is made up of member-state parliamentarians is the Bank's supervisory body which ensures that the Bank is carrying out its mandated objectives. The Board of Directors makes policy decisions concerning the operations and approves the financial transactions proposed by NIB's President. In contrast to the design of many other multilateral banks, this is not an in-house board but a board comprised of member state representatives selected by the respective governments that comes together when necessary. NIB's President is responsible for the conduct of the current operations of the Bank and is assisted by the Management Committee, the Credit Committee, the Finance Committee and the ICT Council.

### *Identifying projects*

While the twofold mandate set the framework for the NIB's activities, the institution nonetheless operates as a bank; it is not an institution for the distribution of public money. An in-house origination team sources potential projects in the markets and assesses every loan according to an internal ranking system in reference to the mandate. Only projects at the top of the scale are accepted. By implication, the NIB rejects a substantial part of funding applications. No one has the right to NIB funding.

In the delivery of its mandate, the NIB is a politically independent organisation with significant institutional integrity; there is no political steering of individual loans. The NIB is a bank and not an instrument of government policy. It is not uncommon that the Bank rejects applications for funding of member-state government initiatives if it cannot be shown that the project furthers the mandate. However, to ensure compatibility with national industrial policies, on the Board, representatives of the member states have the right to veto loans targeted for his or her respective state.

In addition to evaluating projects on their own merits, the Bank takes the state of the economic cycle into account when determining the size of its portfolio. By holding back in economic upswings, the Bank is able to lend in recessions when other creditors typically mend their balance sheets. While limited in volume, this counter-cyclical behaviour is intended to strengthen competitiveness of the member state economies and so contribute to the execution of the first part of the NIB's mandate.

### *Areas of operation*

The mandate necessarily skews the NIB's investment to concentrate on a limited number of core sectors:

1. Energy
2. Environment
3. Transport and logistics infrastructure, and telecommunications
4. Innovation and R&D

The NIB is also involved in SME financing but recognises that its institutional structure with an international hub without local branches is less than ideal for getting to know the business seeking finance. SME financing, therefore, is conducted through intermediaries. Typically, this is done through so-called loan programmes which establish credit lines to local banks with instructions for the use of that money attached. Instructions could, for instance, include using the money to target lending to energy-efficiency schemes. The loans are often given with longer maturities than the SMEs could otherwise access.

### *Track record*

Despite its limited size, the NIB enjoys a AAA rating. With an upper leverage limit of 2.5 times subscription capital – of which only 6% has been paid in – the Bank has approximately €20 billion worth of loans on its books. Nonetheless, over the last 35 years, the NIB has experienced steady growth. Average returns have been in excess of returns on government paper over the same period. While there have been a number of injections of capital into the Bank by the member states since its inception, these have always been motivated by a desire to sustain the growth of the bank – never to offset losses.

Uniquely among multilateral banks globally, the NIB pays dividends to its shareholders. While the economic rationale for dividends could be discussed, these annual payments have imposed considerable financial discipline on the institution. With a high-quality loan portfolio, credit losses over the years have been very low compared to other banking institutions.

## **The European Investment Bank**

### *Background and objectives*

The European Investment Bank (EIB) is the long-term credit institution of the European Union. It was established in 1958, at the inception of the European Economic Community. Its shareholders are all the member states of the EU.

The mission of the EIB is to promote EU priority objectives through investments. It does so in three ways: first, it helps

complete the financial plan of investment projects by providing longer-term capital than is available from commercial lenders; second, it acts as a catalyst for other sources of finance; and third, it makes the project financial plan more sustainable by lowering costs to co-sponsoring borrowers. While private investors might be reluctant to support financially viable projects because of perception of risk, the EIB is in a position to evaluate the projects against its mandated objectives in addition to mere financial returns.

There are three objectives:

1. To promote growth and employment potential
2. To promote economic and social cohesion
3. To further environmental sustainability

#### *Bank structure*

The governing-body structure is similar to that of the NIB. The EIB Board of Governors consists of the EU Finance Ministers who set the policy guidelines. And just like the NIB, the EIB has a Board of Directors. Peculiar to the EIB is the Management Committee – this is a permanent executive body, responsible for the day-to-day running of EIB. The Committee is made up of the President of the EIB and eight Vice Presidents who are nominated by member countries. Finally, an Audit Committee, an independent control body, reports directly to the Board of Governors on the financial and operational status of the Bank.

#### *Operations and project identification*

The EIB's AAA-rating is supported by a strong capital base and the quality of its loan portfolio. The quality is maintained through a rigorous appraisal where all projects must contribute towards at least one of the policy objectives. In addition, they also have to be technically, economically, financially, environmentally and socially viable as well as conform to procurement regulation. As a professional and politically independent body, the project identification process does not take fiscal policy objectives of member states governments into account.

The EIB issues bonds to finance its operations. Despite the lack of sovereign guarantee EIB bonds enjoy a AAA-rating and since the EIB is one of the largest non sovereign bond issuers globally the bonds can be issued at low cost and with very long maturities. As a non-profit institution, the interest that the EIB charges its debtors is merely set to cover cost of funds, operating costs, and to ensure a contribution towards the Bank's financial reserves. In this way, the EIB passes on its low-cost financing to its borrowers.

### *Areas of operation*

Working towards economic and social cohesion in the EU, the EIB provide loans to all major sectors in less advanced regions or countries to help them catch up with the EU average. Just like the NIB, the EIB support SMEs through credit lines to commercial banks. In addition, as majority shareholder in the European Investment Fund (EIF), the EIB offers venture-capital guarantees.

The EIB provides funding to projects that mitigate greenhouse gas emissions, and projects that improve adaptation to climate change impacts. Further, the EIB gives out loans for research and development, education, training, and innovation to promote a more innovative and knowledge based European economy; the EIB finance the 'TENs' (Trans European Networks) supporting the integration of transport and energy infrastructure across the EU. And finally, the EIB invests in the diversification and security of internal energy supply.

While not formally integrated into objectives, the EIB's lending tends to follow a de facto counter-cyclical pattern – providing finance when commercial lending is weak. In the wake of the 2008 crisis, the EIB stepped up its lending significantly. In 2008, the EIB gave out €58 billion in new loans; in 2009, the equivalent figure was €79 billion. Although these are large figures for an individual institution, they are not large enough to plug the funding gap on a European level.

Across all these areas, the EIB offers technical assistance based on experience accumulated over 50 years in addition to financial assistance. Some of the technical assistance schemes

are financed by the European Commission budget. For instance, the European PPP Expertise Centre (EPEC) was recently launched jointly by the EIB and the European Commission to support PPP types of projects – particularly in the Trans European Networks.

#### *Track record*

The EIB subscribed capital is €232 billion, of which €40 billion is paid-in. Just as in the case of the NIB, the maximum leverage ratio is 2.5. At the end of 2010, the balance sheet was 420 billion. This makes it the largest multilateral investment bank globally. €72 billion worth of new loans were signed in 2010 of which approximately 90% went to projects in the European Union. The profit in 2010 was € 2.1 billion. The EIB has enjoyed profits in every single year since its establishment.

#### *Role in the euro crisis*

While the EIB supports the discussions between the European Commission, the European Banking Authority and the ECB with technical expertise regarding the development of term funding solutions for the banking sector, the EIB does not provide any kind of financial support to the recapitalisation or guarantee schemes. In line with other multilateral lending institutions, the EIB has not been asked to take a haircut on the Greece bailout scheme.

## **Lessons learned from the Nordic and European Investment Banks**

1. A public investment bank must be able to demonstrate that it is providing additionality – i.e. that it is offering services that would not otherwise be provided by private institutions. The private sector's inability to offer long-term loans and project stability single out these services as particularly important functions for a Bank. In addition, the involvement of a Bank typically means that cost of capital for private co-sponsors is reduced; the Bank serves as catalyst for investments. With a few exceptions, neither the NIB nor the EIB finance more than 50% of any given project. By imposing such limits they ensure project-ownership participation and, when applicable, involvement of other lenders. It is not uncommon that the NIB and the EIB co-finance projects together when long-term money is needed and the private sector is not there to provide it.
2. A public investment bank should mobilise capital from international capital markets. This requires high portfolio quality and an adequate capital structure for the bank.
  - a. The quality of the portfolio depends on maintaining sound banking principles.
  - b. Adequate capital structure depends on maintaining an active relationship with the shareholders. In order to be able to borrow cheaply against total and not just paid-in capital, markets have to trust the fact that the shareholders indeed are ready to honour their callable capital commitments. In the absence of an explicit government guarantee, credibility is based on a track record of repeated capital increases.
3. A public investment bank should not fund projects which the private sector has rejected on the basis of poor quality. Sound banking principles are essential and this requires political independence in the execution of the mandate in order to avoid political steering of individual project decisions.

# Blueprint for a British Investment Bank

The experiences of the NIB and the EIB provide natural starting points from which to attempt a sketch of the blueprint of a British Investment Bank. What are the institutional and operational characteristics necessary to fill the three functions discussed earlier? Are there existing institutions which – suitably reformed – could fill these functions or is a new organisation required?

## **Mandate**

In order to stimulate the economy without weighing on the Government's books it is essential that a British Investment Bank is capable of attracting dormant private capital. The experiences of the NIB and the EIB in this context point to the importance of a politically independent organisation backed by sovereign capital. A mandate-driven institution with governmental or parliamentary involvement at the strategic level and full autonomy on an operational level has proven to be a model which successfully marries the need for public control over public capital with the need for the maintenance of sound banking principles for market credibility. This is the most likely setup for a British Investment Bank.

There are good reasons to argue that the Bank mandate should mimic the EIB's policy objectives: (1) to promote growth and employment potential; (2) to promote economic and social cohesion; and (3) to further environmental sustainability. The first of these is essential for both the short and long-term

functions of the Bank. With considerable regional differences within the UK, the second objective could reasonably be considered integral to the promotion of national competitiveness. The third has political traction as a long-term necessity.

While this three-legged mandate is wide, it should not be mistaken to be all-encompassing. The Bank should not be everything to everyone; offering additionalities is key. The Bank would execute its mandate by means of offering funding and technical expertise to projects that furthered its policy objectives – funding unavailable through conventional commercial channels. However close the economy is to full capacity, the emphasis on mitigating market failures would minimise the risk of crowding out private actors. The present situation with huge under employed and unemployed resources reduces this risk even further.

## **Operations**

Similar to its peers, the British Investment Bank's mandate suggests a focus on long-term productive assets and employment potential in the areas of infrastructure and SMEs. In both of these the Bank's operations can be divided into financing operations and advisory.

### *Infrastructure financing*

In the current climate where few private institutions are willing to commit to the risks inherent in the early stages of developing large-scale projects but where there is considerable pressure among institutional investors to source existing projects with predictable yields, the Bank's infrastructure involvement can be characterised as an inverted form of the Private Finance Initiative (PFI). Instead of the private sector raising expensive capital to build assets which it then leases to the public sector, the public sector raises cheap capital to build assets which it then refinances into the private sector. By providing such 'confidence bridge' loans or guarantees in the early stages of project development the BIB would ensure that investments with the potential to improve the long-term prospects of durable,

resource-efficient growth of the British economy such as improved facilities for energy and transportation and high-speed internet proceed beyond the drawing board – investments that the private sector is keen to finance at a later stage.

### *Infrastructure advisory*

The Bank would play a crucial role as the Government's centre for project identification, preparation, appraisal and evaluation. This advisory function is core to the Bank's ability to catalyse private co-investment and stimulate aggregate demand. It ensures that a supply of credit is met by a pipeline of prospects. It is also possible that the bank would have the capacity to offer advisory, structuring, and distribution of private infrastructure financing. The Bank's effectiveness would be greatly aided by a simplification of current planning procedures so that projects that have the necessary backing do not get delayed by red tape. The importance of coordinating policies of infrastructure investment and an overhaul of the planning process cannot be overstated.

### *SME financing*

Without a network of local loan offices, the Bank's SME funding would follow the model of the NIB and the EIB and take the form of extending credit lines to local commercial banks to strengthen their SME lending. By taking on the risk of lending to SMEs the BIB could prevent leakages of credit intended for SMEs. It is also possible to envisage close cooperation between the Bank and the recently established Business Growth Fund – the £2.5 billion equity fund set up as a result of discussions between commercial banks and the Government on how to strengthen SMEs. The division of labour between the Bank and the Fund could be modelled on that between the EIB and the EIF.

### *SME advisory*

On top of its financing activities, the Bank could be responsible for the securitisation of existing stocks or new flows of SME

loans. This is an advisory, structuring, and distribution activity and does therefore not require risk absorption capacity. Ensuring that the Bank securitises only the lending of commercial banks and not its own SME lending would avoid a conflict of interest between the need for the securitising entity to scrutinise the quality of the lending entity's loans.

Any aspiration by the Bank to conduct counter-cyclical lending would have to be balanced against its zeal to offer only what the private sector could not. The conventional requirement of finding local co-financing partners risks reducing lending in economic downturns since the appetite and ability of local partners to take on risk are reduced. If, however, the Bank relaxes its co-financing standards in recessions it will inevitably be difficult to justify its lending as purely additive. It would step in to replace private lenders.

### **Political independence vs. policy link**

An issue that needs careful consideration concerns the balance between, on the one hand, the need for operational independence and, on the other, the importance of maintaining a strategic link with government policy. The importance of the former in terms of establishing credibility in the markets and achieving financial sustainability has already been discussed. However, in terms of the Bank's ability to stimulate aggregate demand the latter is no less important.

Government policy creates or kills markets. As a result, the long-term credibility of the Bank both in terms of its borrowing and its credit origination relies on the belief that there will be a policy environment which will continue to address market failures. The degree to which the BIB can leverage funds for green policies depends on there being a credible policy for carbon pricing, standards and regulations; the degree to which the Bank can leverage private money into broadband networks depends on the existence of a recognised policy to roll out broadband networks into the medium term. Private confidence in the viability of large-scale infrastructure and energy investments is to a large extent determined by the length and

visibility of a pipeline of public projects and policies. Without credible policy commitment by the Government, the Bank might find itself pushing on a string in the search for investable projects. There simply would not be enough demand to absorb available funds.

And the problem with insufficient demand for investments is pervasive among SMEs too. Current high levels of uncertainty make it difficult for many companies to identify projects with sufficiently high returns to warrant taking a loan. Also here policy is key. Not only can large-scale infrastructure projects be expected to stimulate demand for firms local to the area of construction such as restaurants and private hire cars, but policy can be directly targeted to creating SME markets. For instance, if the government were to withhold housing benefits from landlords that fail to upgrade their properties according to some minimum standard, it would establish a huge market for local construction businesses.

Interestingly, the Bank itself offers a potential solution to the tension of ensuring political autonomy while needing policy support. It is not unlikely that government ownership of the Bank could serve as a commitment mechanism for policy. That is, if the government has a stake in the Bank's performance it will be less liable to abort policies supporting BIB lending. The value of any implicit government guarantee on BIB bonds would rise if government policy were to negatively impact the BIB's loan book. Insofar as the government marked such guarantees to market in its accounts, it would show a loss. This would serve as a commitment mechanism for maintaining a consistent industrial policy across parliaments.

## **Capital and funding**

Regardless of the institutional structure and areas of operations, there remains the question of how to fund the Bank's establishment. There are two ways in which the Government could finance the subscription capital: it could issue gilts to be bought by the markets and/or the Bank of England; and it could use the profits from selling its equity in commercial banks such

as RBS and Lloyds. The choice between these two is a primarily a question of the treatment in the national accounts. This issue is inconsequential in terms of the functioning of the Bank, but its resolution is nonetheless of vital importance considering the political pressure to reduce the deficit and stabilise the public debt level. If the Bank is perceived to worsen public finances it will never be established.

If the Government were to opt for the first alternative – i.e. to capitalise the Bank out of its budget for capital spending by means of issuing new loans – the deficit would increase relative to the current baseline in the year of capitalisation by an amount corresponding to the new Bank subscription capital. The public debt would increase by this amount. If the Government were to opt for the second alternative – i.e. to capitalise the Bank out of the profit from equity sales – the impact on the budget would be less clear. In effect it would constitute an asset swap and as such it would be neutral for the public debt since the debt and deficits to purchase the original shares have already been incurred. So as to jump start the establishment of the Bank, one idea is to treat the recently established but under-sized Green Bank as the institutional embryo of the BIB. In this case, either of the above capitalisation options would come on top of the existing appropriation for the capitalisation of the Green Bank which is factored into the Government's existing fiscal and public finance projections.

Lending activities would be funded by issuing long-term bonds to private investors. BIB bonds would not be covered by an explicit government guarantee; instead it is the public ownership and the quality of the credit portfolio that would vouch for the institution's credibility. In an economy crippled by uncertainty and with substantial pools of un-invested savings, BIB bonds would offer an attractive option to investors: they would be less risky than corporate bonds while offering a yield higher than that of government gilts. Historically low gilt yields and the ability of even private sector companies to access the bond market at negative real yields constitute strong evidence of the capacity and desire of private savings to fund

long-term, highly credit-worthy, well diversified portfolios. Care would be taken to pass on the Bank's cheap capital costs to its borrowers, but the Bank would aspire to make a modest financial profit from its operations for the purpose of accumulating reserves.

Given the Government's postulated majority stake in the Bank, under current rules BIB borrowing would be registered as liability in the public accounts. This, in turn, would increase deficit projections. A solution to this political problem is to make use of comprehensive balance-sheet accounting that appropriately scores increases in net worth in the Bank's assets. A national investment bank would never fund current expenditure; it would finance investment in productive assets that generate long-term returns. Although BIB borrowing would show up in the Government books it would be financed by revenue from its own activities. This type of borrowing is qualitatively different from tax-financed debt.

### **Other implementation issues**

Setting up a new financial institution with large enough a balance sheet will require parliamentary process and budget appropriations. Building on the existing Green Bank framework is an intuitive way of speeding up this process. In addition, it makes sense to allow for a two-tiered process whereby the advisory business side for both infrastructure and SMEs which does not require a balance sheet is launched ahead of the slower moving financing business. Similar to existing public investment and development banks, the British Investment Bank could start its advisory operations with a high-quality skeleton staff of sectoral experts, with most of the technical work contracted out to the private sector as well as relying on existing expertise from the various government departments such as the Department of Transport, the Environment, Energy, Regions and the BIS.

Simply increasing contributions to the EIB to allow it to fill the functions envisaged for the BIB is not practical from the point of view of UK policy freedom viz. eurozone. This is

particularly important in terms of the BIB's ability to serve as a policy commitment mechanism.

A further aspect of Government commitment pertains to the Bank as an institution in addition to its operations. The privatisation of the Industrial and Commercial Finance Corporation (ICFC) and its transformation into 3i shows how changing governments' changing policies risk bereaving the Bank of its original functions. With the rationales for a public investment bank intact, such an evolution would necessitate the foundation of another public Bank at a later stage. Possible ways of reducing the risk of privatisation include inviting a greater number of shareholders – which could all be public institutions – and/or designing a federal institutional structure.

## Conclusion

With mandates to promote competitiveness, growth and environmental sustainability, the Nordic and European Investment Banks have for decades leveraged relatively small amounts of public capital in the private markets to strengthen lending to infrastructure and SMEs. Enjoying complete operational autonomy, the Banks assess each project in terms of its long-term return – economic as well as financial. The Banks are not investing in projects rejected by the private sector because of poor quality but finance activities that the private sector has rejected because of inability to fund. Neither bank has ever had to exercise its right to capital replenishment to offset losses; both banks have consistently registered profits.

With low risk appetite among lenders and crippled confidence among borrowers, the British economy is inundated with dormant private capital. At the same time, UK infrastructure and SMEs need investment to sustain standards and contribute to growth and employment. Following the example of its Nordic and European peers, a British Investment Bank could step in and clear this blockage in the financial system.

In combination with simplified planning procedures, the Bank could stimulate demand by boosting private-sector confidence in both policy commitment and project viability. This is particularly important to set the economy on a path to recovery in the short run. But there are good reasons to establish the Bank also for the long run. SMEs have suffered from the Macmillan funding gap for at least 80 years; and also in good times infrastructure projects struggle to find tail-end finance. And in addition to financing, a British Investment Bank would

play an important role as a centre for project identification, preparation, appraisal and evaluation.

To avoid a second recession, the UK economy is in desperate need of a growth plan. A British Investment Bank is not the only way to growth but it offers a solution both to the insufficient supply of, and the insufficient demand for, credit without burdening public finances significantly. After the failures of Plans A and B, a British Investment Bank is a concrete proposal for Plan C.

## Participants at the British Investment Bank conference, Westminster, 2 November 2011

Andrew Johnson (EEF – Manufacturers' Association)

Chi Lo (HFT Fund)

Cormac Hollingsworth (for Gordon Brown MP)

Crispin Williams (Association for Consultancy and  
Engineering)

Darryl Murphy (KPMG Infrastructure)

David Merlin-Jones (Civitas)

Dmitri Zenghelis (LSE)

Felix Martin (Thames River Capital)

George Irvin (SOAS)

Gerald Holtham (Cadwyn Capital)

Gerard Lyons (Standard Chartered)

Giles Wilkes (for Vince Cable MP)

Gonzalo Ramos (former EBRD)

Daniel Ottolenghi (European Investment Bank)

Ha-Joon Chang (University of Cambridge)

Harro Pitkänen (Nordic Investment Bank)

Jeff Masters and Harry Holdstock (for Chuka Umunna MP)

Jo Johnson MP

John Weeks (SOAS)

Karl Richter (Jen Li Foundation)

Kitty Ussher (former Treasury minister)

Larry Elliott (Guardian)

Lord Liddle (Policy Network)

Louis Mosley (for Rory Stewart MP)

Marilyne Tolle and Tomas Hellebrandt (Bank of England)

Michael Burke (former Citibank)

Norman Price (Chair, West Midlands Enterprise Board)

Tim Armstrong (Dept for Business, Industry and Skills)

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