A NATIONAL INVESTMENT BANK FOR BRITAIN:

Putting dynamism into our industrial strategy

REPORT TO THE SHADOW CHANCELLOR OF THE EXCHEQUER AND SHADOW SECRETARY FOR BUSINESS, ENERGY AND INDUSTRIAL STRATEGY ON IMPLEMENTATION

Labour
labour.org.uk

CONTENTS

We would like to thank Rob Calvert Jump, Rod Dowler, Diane Elson, Daniela Gabor, Sue Himmelweit, Leandros Kalisperas, Michael Lloyd, Ozlem Onaran and Andy Ross for their contributions to this document. The document reflects the views of a number of these, and others; its contents should not be taken as representing the views of any of its authors.

This report is the work of external experts and constitutes a report to members of the Shadow Cabinet. It should not be taken to represent Labour Party policy.

INTRODUCTION

In July 2016, John McDonnell MP, Shadow Chancellor of the Exchequer, announced Labour's support for a National Investment Bank and network of regional development banks as part of Labour's pledge to rebuild and transform Britain. The NIB and RDBs form part of Labour's promise to mobilise £500bn of investment over ten years to redress many of the structural problems in the British economy, a figure which includes both public sector and private sector financing.
The existing financial system has proven inadequate for the purposes of much of the UK economy: in addition to widespread criticisms of short-termism and a failure to invest in the economy for the long term with investment disappointing by international comparisons, wide disparities have emerged between our regions and nations.

The idea of a National Investment Bank is not a new one, nor one without international precedents. Different forms of state-backed banks already exist in many countries and sub-regions, including Germany, Canada and North Dakota, and a British counterpart should be able to learn from best practice elsewhere in the world.

It should be noted that the NIB and RDBs are not designed to be an alternative to public spending commitments through normal department spending limits, whether on revenue or capital accounts. The July 2016 speech by John McDonnell referred to a programme of public capital expenditure, averaging £25bn per year over ten years, as part of what is needed to address the shortfall in infrastructure spending, and the £250bn lending target of the NIB and RDBs is in addition to this.

Since then it should be noted that the incoming Chancellor of the Exchequer, Philip Hammond MP, has implicitly conceded the need for greater public investment, while refusing to take it seriously, with a token increase in capital expenditure of £27 billion over the next five years.

The aims of this working group are to consider some of the important questions about the implementation of the National Investment Bank: how it relates to our industrial strategy, how it is funded and structured, what should be its aims and structures, and how Labour should go about its implementation.

The contents of the report are the conclusions of the group overall, not always unanimous, and so should not be taken to represent the views of any single member of the working group.

EXECUTIVE SUMMARY

- The principal funding recommendation is that the initial financing of the NIB should be via a £20 billion government bond issue. This equity financing would cover the costs of establishing the bank and its regional offices, running costs, and initial on-lending. Subsequent annual issues, guaranteed by the UK government, would increase the size of the NIB balance sheet to approximately £250 billion by the end of a ten year period.

- The on-lending structure of the NIB will avoid any direct competition with conventional banks. This mode of operation will also avoid any political problems for the policy as the British Business Bank operates in an analogous manner, i.e. as an intermediary, and has been cleared by the EU under the state aid rules.

- The National Investment Bank will have a two-tier board structure: a Supervisory Board including representatives from unions, business and local government, and an Operating Board responsible for day-to-day management.

- Twelve regional development banks will be allocated funding centrally in line with the Aims and Mandate of the National Investment Bank.

- While accepting that political objectives will sometimes moderate financial outcomes, the NIB will be staffed to include people with top level banking and commercial skills able to deliver strong regional and national economic benefits and thus create an institution that will endure and have wide and hopefully cross-party support.

ONE

Aims

The National Investment Bank and associated regional development banks are an ambitious blueprint for providing funding on a sufficient scale to meet the needs and potential of the UK's small and medium-sized enterprises[1], and by transforming the operation of the UK's financial system through the creation of new institutions accountable to the public and wider social goals, in a sustainable, regionally-balanced and equitable way.

The National Investment Bank and network of regional development banks is a response to the failure of the UK banking sector to provide longer- term loan funding for enterprises, for small and medium-sized enterprises especially, or to support innovation in forms of productive organisations.

The failure has been longstanding, first receiving official recognition in the 1932 Macmillan Committee report. Despite attention from successive governments, the problem remains entrenched and has worsened sharply since the 2008 crash. The weakness of lending to businesses and local projects outside of London is particularly pronounced.

More broadly the ambition of the National Investment Bank and regional development banks is to work in a context of a long-term industrial strategy and economic policy intended to permanently reshape the British economy so that it is fairer, more democratic, less wasteful of resources and able to meet the challenges and opportunities of Brexit.

[1] Throughout this document, 'enterprises' should be taken to refer to both businesses and appropriate non-profit or third sector organisations

TWO

Mandate

Our proposed draft mandate, which would serve as a draft legal objective for the National Investment Bank's articles of association, is as follows:

The objectives of the company are:

A. To deliver public policies, in particular financing, pursuant to a Government mandate in the following areas:

   a. Addressing the long term funding gap to small and medium sized enterprises
   b. Addressing the long term funding gap for infrastructure investment, both physical and social
   c. Addressing the long term funding gap for technological and institutional progress and innovation
   d. Any other areas assigned to the National Investment Bank by the Government including organisations providing socially valuable services
   e. Addressing the long-term funding gap for small and medium-sized businesses and high-value local projects in regions outside of London and the South-East.

B. To do so in ways consistent with government policies in other areas

C. To achieve the objectives set out in (A) by making, facilitating, engaging in, and encouraging investments, lending and related activities including (without limitation) by or with respect to (i) the lending of money, (ii) the grant or provision of credit or other related and appropriate support, (iii) the investment of money in investments and other financial assets (including (without limitation) securities (whether debt or equity or hybrid in character)) and to hold, sell or otherwise deal with such investment or other financial assets, (iv) the grant or provision of guarantees, security, insurance or support, or (v) the grant or provision of other financial products, in all of the foregoing cases, with or without interest, security or consideration, and whether directly by the company as lender, investor, co-investor or in any other capacity or through financial intermediaries, which the board considers will, or are reasonably likely to, directly or indirectly, facilitate the Bank's objectives.

D. To act as a holding company, and

E. To do all other things that the board considers ancillary, incidental, or conducive to the attainment of the foregoing objects and the company shall have any and all powers which the board considers ancillary, incidental or conducive to the attainment of the foregoing objects.

THREE

Funding

3.1 The National Investment Bank (NIB) will follow an on-lending strategy similar to the KfW Mittelstand activity in Germany. The NIB will be funded via its own bond issuance (with the backing of a UK government guarantee), following initial equity financing by the Government. The NIB structured on this basis would not be a competitor to private commercial banks. The approach works by substantial discounting of the funding costs of the banks directly lending to businesses, corresponding to substantial reductions in risk via lower interest rates over long-dated loan terms provided by the NIB. This approach will enable private banks to avoid risk-averse asset-backed approaches when lending to SMEs, providing a relatively high leverage ratio for the NIB.

3.2 Although there have been attempts via various initiatives (e.g. the BBB) and schemes (e.g. Funding for Lending and latterly the BoE Term Funding Scheme) these have not changed the character of lending to SMEs, particularly medium-sized businesses, in respect of long-term finance to stimulate and sustain a long-term, innovative approach by this key cohort of businesses.

3.3 The NIB would initially issue an equity tranche of £20 billion, which would be purchased by the UK Government. Over the ten year policy horizon, the NIB would conduct ten annual bond issues, which would expand the NIB balance sheet to approximately £250 billion by the tenth year. This would correspond to approximately £250 billion of long-term on-lending to private banks over the policy horizon. Therefore, an initially low leverage ratio (equity-debt ratio) would rise to approximately 8% at the end of the 10 year horizon.

3.4 The proposed final leverage ratio is still relatively high compared to commercial banks. This reflects the on-lending character of the NIB, which seeks to replicate the 20/30 year regular loan-term finance framework provided in Germany via KfW on-lending to German SMEs

3.5 The £20bn equity issuance should take place in the initial year of the policy, rather than £2bn equity being issued per year, to reduce both the Government and NIB funding cost over the policy horizon. Given current extremely low interest rates, issuing £20bn in government bonds in the initial year should be a lower cost strategy than spreading out the bond issuance over a ten year period, on the basis that this will minimise the impact on government borrowing. This also suggests that long-dated government bonds would be the appropriate issuance. Moreover, the NIB will build up a satisfactory credit rating over time, and therefore the yields on NIB bonds should decrease over time, or at least rise at a slower rate than government bond yields in the event that the latter rise. Finally, it should be noted that a one-off issuance of £20bn government bonds corresponds to approximately 1-2% of the outstanding public debt.

FOUR

Relationship with the existing sector and regulation

4.1 In order to get market reach and market penetration quickly, the NIB will work through selected existing banks to deliver loan facilities. Such partners will be chosen for their understanding of NIB aims, their performance in delivering these, and their standards of corporate governance. It appears intuitively likely that smaller challenger banks will be more inclined to work in the ways preferred by the NIB but all potential partners, including the large commercial banks should be explored.

4.2 The NIB will operate via on-lending, at discounted rates to other smaller private and savings and cooperative banks (after the fashion of KfW). The key to its successful operation in the UK will be to establish links with a significant number of commercial banks.

4.3 A change in banking culture will not occur without partner banks clearly understanding NIB goals and being given incentives to meet them. The NIB will need to specify the terms on which it will do business with partners and the products it will offer its target markets in terms of regions and sectors. The target markets will be assessed on factors such as regional investment gap or opportunity analysis rather than the current Treasury approach of maximising net present value that tends to favour investment in the South East. Partner banks will be assessed on their lending performance and poorly performing partners will be dropped. This should act as an incentive for partners to develop investment appraisal skills that many have dropped in favour of a national algorithmic approach. Assuming an 'unleveraged' programme in year 1, or possibly also into year 2 - a transitional period is likely to be necessary - the 'return' for NIB would be loan rate less government bond rate, less start-up costs, less losses. It might be possible to get partner banks to shoulder some of the start-up costs in order to get in at the start of the programme.

4.4 One practical issue relates to the focus of these smaller new entrants. Some may act as expanded credit unions, others may target digitally savvy, younger retail customers, rather than SMEs. Alternatively they may simply offer commercial property mortgages or asset-based loans. A connected issue is the current banking regulations that favour retail mortgages over business loans. Clearly, it will be safer for a conventional bank to lend against a marketable physical asset than simply to assume a non-asset based commercial risk in relation to a large, long-term business loan.

4.5 Freeing the banks from these constraints is the main aim of having a NIB. Effectively, on-lending from low interest rate bond finance to enable discounted long-term loans to be offered to appropriate companies. The principal advantage of the NIB in regard to risk is the ability, by the banks lending directly to businesses, to discount substantially the risks involved in non-asset backed business loans, and the even more substantial risk with long-term loans of 20 to 30 years. It is important to recognise the magnitude of the change envisaged, albeit a gradual change over a period of years.[2]

[2] Steps will need to be taken to prevent banks from calling in current loans and using NIB funding to raise profits on what are really existing loans but reported to the NIB as new loans.

4.6 The advent of the NIB will facilitate developing partnerships with the so-called challenger banks. These banks will include digital banks such as Atom as well as the more long-standing challenger banks such as Metro Bank.

4.7 In fact there is a plethora of potential new banks, as well as recent, already licensed challenger banks. Not all of the new banks would necessarily be suitable on-lending partners for the NIB. It will depend on the focus and ambitions of the banks, and their willingness and ability to act regionally. A number of the new banks may opt to concentrate on personal retail banking rather than business banking. Moreover, the skill sets of those in these banks, as well as those in the NIB, will need to be wider than those deployed in the major commercial banks. There will also need to be access to those having strong market analytical abilities across sectors and technologies. Part of the risk-averse nature of UK banking arises from the focus and remit of the banks; though it is also related to the inherently riskier nature of non-marketable assets that leads to higher levels of capital coverage by banks.

4.8 The UK banking market is widely regarded as unsatisfactory with the dominance of four major banks and a difficult environment for smaller banks and the new challenger banks to establish themselves. The situation is ripe for a National Investment Bank to enter the market and change the culture of banking by launching new low cost lending facilities clearly targeted at currently neglected but promising regional and sectoral markets.

Regulatory framework

4.9 The general point to note is that Basel III and CRD IV regulatory standards and implementation frameworks aim to define boundaries around the dynamic optimisation process (of capital, liquidity etc) within listed bank entities. The NIB has no intention of optimising in any such manner, and so notwithstanding that the NIB will maintain appropriate standards irrespective of whether it falls under such frameworks, it will not be testing parameter limits.

4.10 CRD IV is intended to implement the Basel III agreement in the EU. This includes enhanced requirements for: the quality and quantity of capital; liquidity and leverage requirements; counterparty risk; and new macroprudential standards including a countercyclical capital buffer and capital buffers for systemically important institutions.

Taking each in turn:

(a) The quality and quantity of capital will be high. Capital will be injected as pure equity and therefore will be of the highest quality; its quantity will be sufficient such as to generate a high intrinsic rating (should a capital market model be used) and a high overall rating (given the underpinning of a government guarantee).

(b) Liquidity requirements will be low. The most serious liquidity requirement relates to the asset-liability term mismatch, and the NIB by borrowing long term from investors will not face any significant day-to-day liquidity requirements. There may well be second order cashflow requirements arising from hedging of interest rate and FX risks, but these will be handled within the overall capital framework. Leverage will be moderate given the quality and quantity of capital.

(c) Counterparty risk as defined in regulatory frameworks take the form of various settlement risks, and within listed bank entities are mostly related to derivatives. The NIB will not be a big user of derivatives, so this will be a low risk.

(d) The NIB will not be a systemically important institution domestically or internationally (target of c.10% of GDP achieved over several years, relative to an existing UK banking system of 300-400% of GDP depending on definition used), and in any event will not be looking to hoard or distribute capital in manners that are relevant for this concern.

4.11 As the government will be the sole equity holder of the NIB, and will under-write the NIB bonds, the relation of the NIB balance sheet to the public sector balance sheet would be subject to discussion. We would aim for the NIB to be treated in the same manner as the KfW in Germany, i.e. considered a separate object for the purposes of public sector accounting, according to the European System of National and Regional Accounts (ESA 2010)."

FIVE
Management structures

The management of the NIB will be achieved via a two-tier board structure as indicated below.

Supervisory Board of Directors

5.1 The supervisory board (SB) will be responsible for setting the overall policy framework of the NIB, within the parameters set by government policy; for allocating the resources available to each of the regional branches (in consultation with the Operating Board, OB), and for appointing and overseeing the OB and the efficiency and equity of the OB operating mandate. The SB will also be responsible for the appointment of the Chief Executive Officer (CEO) of the NIB, on a 3-year, renewable contract. The CEO will be accountable to the SB and will report quarterly. The CEO will be also accountable directly to the Government and to Parliament in relation to the expenditure of public money (as with the CEO of the BBB).

5.2 To avoid having to split into sub-committees, it is suggested that the SB should not be large, but should be of a size sufficient to be representative. It is suggested that the chair should be either the Chancellor of the Exchequer (or, as a substitute, the Chief Secretary) or the Secretary of State for Business, Energy and Industrial Strategy, etc. (or, as a substitute, a senior Industry Minister).

5.3 The remaining members will include senior ministerial representatives of Scotland, Wales, and Northern Ireland, the Leader of the LGA and two other council leaders from outside London, the General Secretary of the TUC and one other senior trade union general secretary, the Director-General of the CBI and one other senior business representative. The directors would be, under UK law, remunerated non-executive directors. Their remuneration will be set by the government.

5.4 There will be a separate Audit Committee of four SB non-executive supervisory board members, and chaired by a nominated member of the SB. The external auditors would be appointed, by the audit committee, for a period of three years and then changed.

5.5 There will also be a Remuneration Committee, again drawn from the SB, which will receive recommendations from the OB.

Operating Board

5.6 The role of the Operating Board (OB) will be to be responsible for the overall national framework of the bank's operations at national and regional level. The CEO will report on a quarterly basis to the OB on the operational management of the bank, including its regional branches.

5.7 The OB would comprise some seven executive members, including the CEO of the NIB, and non-executives. The executives would be professional managers with qualifications covering banking practice, applied economics, financial accountancy, with business experience. Three of the seven would be drawn from the directors of the regional branches of the NIB. Their remuneration will be set by the SB.

5.8 The regional branches will have Regional Directors, appointed by the CEO, subject to the approval of both the SB and the OB, on 3-year, renewable contracts. The regional directors will report nationally to the CEO, and where required to the OB, and to a Regional Board (RB).

5.9 The RB will comprise seven members drawn from the region representing business, trade unions, local authorities, and civil society more widely.

National and Regional Operations

5.10 As noted in section 1, a key objective of the NIB is to support the objectives of industrial and economic policy, both in manufacturing and services, which lead to sustainable, regionally-balanced and equitable economic growth in the long term.

5.11 In order to achieve this, the NIB will consist of a head office located outside London, and 12 regional development banks. These will be located in each of the nine regions of England, plus Scotland, Wales, and Northern Ireland. Possible locations for the head office include Sheffield, the current location of the BBB head office, Birmingham, or Leeds.

5.12 The regional offices will establish, as rapidly as possible, relationships with private and public local banking institutions, e.g. digital banks and challenger banks, as per section 4 above. The main advantage of regional offices is the ability to take advantage of local networks and knowledge, which, given the quantity of annual funding involved, is unlikely to be feasible for a centralised institution. Moreover, on-lending via regional offices will be more accountable to regional stakeholders via regional boards. For the devolved administrations, management and oversight of the development bank will be left to the devolved government to establish, within the broad framework suggested here. It is essential for the development banks to maintain a strong working relationship with the NIB as this will give them far greater access to capital and risk-sharing that would not otherwise be available.

5.13 The regional branches of the NIB, acting under regional boards and with autonomy in regards to the direction of on-lending, will be regional development banks. Both financial economies of scale and organisational transparency suggest that a regional branch system is superior to legally distinct regional entities. A corollary of this is that regional branch funding will be allocated centrally.

5.14 As noted in section 3, the NIB will expand its balance sheet to approximately £250 billion over a ten year period. The annual resources of each of the regional branches, set by the SB in consultation with the OB, will be allocated with a view to taking advantage of local opportunities and to closing the extreme disparities in infrastructure investment and high productivity employment between the South East of England and the rest of the United Kingdom. Given the location of significant manufacturing output and employment in the Midlands and North of England, Scotland, Wales, and Northern Ireland, resource allocation could also target sectoral rebalancing of the UK economy.

SIX

Initial steps to implementation

Strong consideration needs to be given to the initial set-up and culture of the NIB. Ideally, what is needed is a high performing, innovative organisation which fully understands Labour's industrial strategy aims and can move swiftly to support and sustain these. The following steps are set out as a first draft plan that will require further research and discussion.

1. Set up a small Steering Board of non-executives who understand and are committed to the goals of the NIB.

2. Use this Steering Board to recruit a small Executive Team. This team would establish the initial culture of excellence, high achievement and values of the NIB. They could be recruits or secondments from finance and/or industry, and also sector specialists in energy, software, civil engineering, transport etc.

3. The Executive Team would take the executive roles in the NIB Operating Board and the Steering Board would fill the non-exec roles.

4. Legal and accounting advice will be needed in establishing the NIB. If it is agreed that the BBB is the best launch vehicle, care will be needed to ensure that integration with the existing staff and operations proceeds smoothly.

5. The NIB launch team could probably get initial accommodation on a temporary basis from a variety of sources including partner institutions or the BBB. This would help avoid commitment until the emerging accommodation and staffing needs of the bank become better defined.

6. The NIB Launch Team will need to move quickly to define its launch products and initial target markets. These should dovetail closely with Labour's industrial strategy.

7. Once the products and target markets are defined, the NIB would be in a position to invite tenders from commercial banks to become launch partners. It would be advisable to talk informally to a number of potential partners before issuing formal tender documents. Pitched correctly, it should be possible to get competition for a restricted number of launch partner opportunities.

labour.org.uk

9284_17 Reproduced from electronic media, promoted by Iain McNicol, General Secretary, the Labour Party, on behalf of the Labour Party, both at, Southside, 105 Victoria Street, London, SW1E 6QT.