



HOUSE OF LORDS

Select Committee on the European Union

EU Financial Affairs Sub-Committee

Oral evidence:

Brexit: the European Investment Bank

Wednesday 24 October 2018

10.15 am

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Members present: Baroness Falkner of Margravine (Chairman); Lord Bruce of Bennachie; Lord Butler of Brockwell; Lord Cavendish of Furness; Lord De Mauley; Lord Desai; Lord Giddens; Baroness Liddell of Coatdyke; Earl of Lindsay; Baroness Neville-Rolfe; Lord Vaux of Harrowden.

Evidence Session No. 3

Heard in Public

Questions 30 - 41

Witnesses

I: Laurie Macfarlane, Public Banking Lead, UCL Institute for Innovation and Public Purpose; Josh Ryan-Collins, Head of Research, UCL Institute for Innovation and Public Purpose.

Examination of witnesses

Laurie Macfarlane and Josh Ryan-Collins.

Q30 The Chairman: Good morning. We welcome to the European Union Financial Affairs Sub-Committee evidence session on Brexit and the European Investment Bank Mr Josh Ryan-Collins, Head of Research, and Mr Laurie Macfarlane, Public Banking Lead, from UCL Institute for Innovation and Public Purpose. You have before you a declaration of members' interests. The session is being broadcast on parliamentlive.tv. A full transcript is being taken and will be made available to you shortly after the session, and you will be able to make minor amendments as you wish.

What do you see as the unique role of the European Investment Bank? It is very well known for infrastructure investment, and we have taken a lot of good evidence on that, but do you believe the EIB is good at supporting small businesses, in particular innovative companies and innovative finance. If you have any brief opening statements, you are very welcome to make them.

Josh Ryan-Collins: If I may, I will make a quick opening statement about the institute's overall philosophy. It was launched last October and is directed by Mariana Mazzucato. The focus of the institute is that we need to take a slightly different approach to the role of the state, and the public sector more generally, in regard to economic growth. To summarise it briefly, the mainstream economic view of the role of the state in the market is, essentially, one of market fixing: you identify a market failure, and the role of the state is to come in, lubricate and fix that failure.

Our perspective is that the state has a role in shaping markets, as it always has done, not on its own but collaboratively with the private sector and sometimes with civil society groups. All markets are outcomes of that interaction between different sectors. Historically, there has never been a market that has not had a set of rules or regulations with the public sector involved. If we think about markets in that way, it gives us a slightly different perspective on some of the issues we are talking about today, rather than thinking purely of the market being over here and the state being over there, and then the state comes in when there is a problem. I wanted to set out that overall perspective. On the question itself, Laurie is perhaps better qualified to respond.

Laurie Macfarlane: Thank you very much for having us today. It is a great pleasure to share some thoughts.

On the question of the unique role of the European Investment Bank, like most other state investment banks or development banks, as they are sometimes called, its basic role is to change and influence both the volume and direction of investment in the economy. Economic growth and innovation does not just have a rate; it also has a direction. That direction can be in different ways.

In our work, we have developed a typology of the economic role that institutions such as the EIB can play in economies. To different extents, the EIB plays four roles. I will briefly outline what we describe as each of those roles and then we can go into some of them in more detail if you like.

The first is a countercyclical role, which is very much a case of providing finance throughout the swings of the business cycle and lending against what can often be the pro-cyclical nature of the private financial sector. That is a role that institutions such as the EIB have played historically. Recently, the EIB notably and importantly played that role, stepping up in 2012 to offset the downturn in lending across Europe.

We would describe the second role as capital development. The role is really about providing financing for infrastructure, which you mentioned, and basic public goods, often for firms and SMEs that struggle to attract finance from elsewhere. It is about fixing that kind of market failure. It can also be about promoting export finance. Sometimes that is done by a separate institution promoting strategic trade. Historically, providing basic infrastructure finance, and finance for some SMEs, has been the main role of the EIB across Europe and in the UK.

In addition, the EIB and many other state investment banks have started to take on two new and different roles in more recent years. The first we characterise as a venture capital role, oriented around promoting and fostering innovation on the basis that innovation is by its very nature long term and uncertain, and requires a very specific form of finance, at least often in the early stages: long-term patient, committed finance. Those are areas where the private sector does not often go. It might not want to invest when returns are not certain, so providing early-stage patient finance is an area where, historically, public sources of finance have played an important role; it is not always state investment banks but can be research development agencies or public venture capital funds.

When we look around the world, we find that such finance is increasingly being provided by state investment banks. The EIB in particular has upped its activity in that field in recent years. The EIB is the majority shareholder in the European Investment Fund, which specifically promotes innovative companies, often in the form of equity finance rather than debt finance. It has a number of specific programmes and instruments that play that specific role.

Finally, there is what we call a mission-oriented role. As Josh alluded to, as well as seeking to fix market failures, the EIB seeks to create and shape new markets, particularly those that address specific societal problems, sometimes called grand challenges. By placing state investment banks at the centre of an investment strategy, Europe, particularly the KfW in Germany, has taken a key leading role in addressing some of the challenges, particularly on climate change and the environment. In this space, the EIB has played an important role in promoting the EU's agenda of smart, sustainable and inclusive growth, particularly addressing climate issues. The EIB aims to direct 25% of all

its lending towards addressing climate change adaptation and mitigation and support of low-carbon growth.

I hope that provides a reasonably high-level review of the different roles that the EIB and other institutions tend to play in supporting not only infrastructure but businesses and SMEs.

The Chairman: That is really helpful. Thank you very much.

Q31 **Lord Desai:** You have already explained the many things the EIB does. How good has it been for the UK in investment? Is the UK good compared with the rest of Europe or are we lagging? Is it the case that other national supporting institutions are needed to make the EIB work better?

Josh Ryan-Collins: When you refer to other national institutions, what do you mean?

Lord Desai: We might need the British Investment Bank to run alongside the EIB, because the EIB can only do so much, and we have to do something on our own.

Laurie Macfarlane: Maybe it would be useful to provide some big-picture context to show what the EIB has done in the UK. Since 1973, the EIB has invested £165 billion in UK projects. That is about 9% of the total amount of investment it has undertaken during that period. How does that compare with other countries? The UK holds about 15% of capital in the EIB.

Lord Desai: It is also a much larger share of EU income—more than 9%.

Laurie Macfarlane: Yes. In one sense it has received less proportionally. That is partly because one of the EIB's key objectives is to support the less developed areas of Europe, to promote convergence and so on. None the less, it has played quite an important role. It has invested quite a lot of money in infrastructure: water, wastewater, urban projects, housing and redevelopment.

It is important to put that in perspective. The year before the UK referendum, the EIB invested about £7 billion in the UK. That was a lot of money and it was very important for specific sectors. We need to be aware of that and not forget it. At the same time, in the context of the UK's economy and its particularly low level of investment, in terms of GDP it is about 118th in the world. There is a lot of evidence linked to these low levels of investment.

The Chairman: Where does it rank in the EU 28?

Laurie Macfarlane: It is fifth from the bottom in the EU, behind Greece and Portugal—the four countries that have been in very difficult times. The level of investment in the UK is comparatively very low. What is particularly concerning to me is that, on a net basis, deducting depreciation, or capital consumption as it is sometimes called, the UK's productive capital stock has been declining on a per employee basis since

2011. We are not investing enough even to maintain our capital stock at a consistent rate to account for population growth. It is therefore not surprising, at least to me, that we have productivity stagnation and wage stagnation.

On the point about other institutions, it is important to stress that the EIB exists to promote EU policy objectives. That is what it is there to do; that is its role. We have been a member of the European Union, so EU policy objectives have been relevant to the UK and we have benefited from EIB funding. A whole bunch of other policy objectives of the UK Government might be different from that and obviously the EIB cannot support them. Whether before or after Brexit, that is where potential opportunity lies for a UK-focused institution to support UK Government policy objectives.

Lord Desai: I was going to ask you about policy priorities. Does the EIB have special expertise, or is it lucky? Has it built up good policy expertise so that it can spot good projects?

Laurie Macfarlane: Yes. One of the main benefits of the EIB and other successful state investment banks such as the KfW in Germany and the China Development Bank is that their staff have a wider range of professional expertise than in, say, typical private financial firms. They have financial and economics expertise. The EIB also employs significant engineering or scientific expertise that provides a broader way to assess projects, looking not just at prices and market signals but at fundamentals. That is quite important for its ability to crowd in private sector investment. If the EIB is a first-mover investor in something, it gives other investors the confidence to say, "The EIB has looked at this and appraised it robustly using its wide range of expertise". It gives them confidence to come in and invest. That is certainly a strength of the EIB, and something we would obviously miss if we were no longer a member.

Josh Ryan-Collins: On the relative importance of the EIB and state investment banks more generally, we did a quick calculation before we arrived here. Although £7 billion sounds like a large number, relative to total fixed capital investment we worked out that it represents only 2% to 3% in the UK. It is obviously very important in certain key sectors it disproportionately supports—housing is definitely one of them—but compared with the total it is not huge.

The broader point Laurie is making is that Germany's state investment bank, the KfW, has a balance sheet of about 20% of GDP for the whole country. By comparison, in the UK, the combined assets for the old GIB, the business bank, are 1%. These are slightly old figures, but they will not have changed greatly. There is a massive difference. The Brazilian state investment bank is around 12%; the Japanese state investment bank is at 5%. The key thing is that the UK is very unusual and idiosyncratic in not having a large state investment bank. We are the only one of the advanced economies not to have one. We have the lowest level of fixed capital investment in the G7; it is about 16% on the latest figures.

Lord Desai: The US also does not have a state bank.

Josh Ryan-Collins: The US does not have a state bank, but it puts a lot more state money into innovation. It has enormous military innovation, through DARPA, and an environmental version of that. The US generally puts more money into early-stage research and it has a much stronger venture capital sector. Although the US does not have an SIB it does not really need one to the extent we do. China has four or five very large state-run banks; by balance sheet, they are some of the largest in the world.

The point Laurie was trying to make is that, if you do not have a large state or public investment bank you do not give finance direction and create opportunities in the way that can happen if you have that kind of institution.

Lord Desai: Are you saying that is a market failure?

Josh Ryan-Collins: You can call it a market failure if you want. I would call it market shaping.

Lord Desai: Historically, the UK had a much more developed banking system compared with other countries, so it did not have that sort of bank, and the equity market performed very well. It may be that you think the UK has a market failure and that is why it needs it.

The Chairman: We are coming to market failure later.

Lord Vaux of Harrowden: Can I ask you about the crowding in point? The key thing is that the EIB, or any investment bank, is not just duplicating what the market would otherwise do. How successful has it been in bringing in, alongside its investing, private sector finance that would not otherwise have happened? Are there any numbers that you can give us?

Laurie Macfarlane: In a way, that is the million dollar question: what is the level of additionality it is providing? I am aware that internally the EIB is constantly trying to assess the extent to which it provides additionality and where the opportunities are. To my knowledge, it does not provide figures for that externally, but the key thing that such institutions should be thinking about is where they can do things that are not happening already, and add value and provide that additionality. Historically, the EIB has been reasonably successful on classic market failures such as infrastructure and SME stuff in different countries in Europe.

The more interesting stuff is around the other two roles: venture capital and the mission-oriented stuff. The EIB and other European state investment banks have been quite important in laying the ground in a lot of green investment; they have been leading investors in clean energy tech, for example, and playing a lead role in forming the green bond market, which is now widely adopted. The private sector is now very

much involved in that, but it was pioneered and led by the EIB and others.

In designing such things, the key point is always to bear in mind where the opportunities are for additionality. One of the things we are working on in IIPP is the whole issue of the monitoring and evaluation of these institutions. Often they are monitored or assessed according to metrics that may not necessarily make sense for what they are doing. They are very narrow or financial metrics that we would apply to other things. We need to develop metrics that are able to capture additionality and, more importantly, not just in a static way, which would be to look at what has just happened that would not otherwise have happened. We need to look at the dynamic spillovers further down the line and the opportunities created by them. That is something we are working very hard on. Institutions such as the EIB need to do much better at demonstrating clearly that they are creating additionality.

Lord Cavendish of Furness: Pursuant to the argument, if I heard it right, that as a country we are pathetically low on the scale of investment, we probably all have ideas about why that is, but what is your view?

Josh Ryan-Collins: Essentially, the UK is on what we might call a debt-led and consumption-led growth trajectory, whereby we generate growth mainly through consumption, not investment. Much of that consumption is enabled by households taking out loans, either consumer loans, which have been one of the fastest-growing credit aggregates since the financial crisis, or home equity withdrawal. A secondary effect is rising house prices; there is a sort of wealth effect. There is a very close correlation between the level of home equity withdrawal and consumption.

That is not a sustainable model. It is a very inefficient way of creating growth because you need quite a lot of debt to keep consumption growing. Eventually, the stock of debt starts to bear down on people's ability to spend, so their debt-to-income level becomes too high. It also means that the Bank of England gets very nervous about raising interest rates because the level of debt is so high. It also means that productivity is low because we are not investing; we are not making the capital investment, or the investment in R&D, required to have the sort of investment-led growth that we see in Germany and some other European countries, and to some extent in the US.

The reasons for that are many. One of them is that in the 1980s we decided to deregulate our financial sector much faster than most other countries. That led to a very important shift in what banks in this country actually do. They turned from their textbook role, which was to lend to non-financial businesses for working capital and investment, to be, now, mainly mortgage lenders. In 1986, about 35% of all UK bank loans supported production, broadly defined as lending to non-financial firms—and that is now down to less than 10%, give or take a few per cent. In contrast, in Germany, it is closer to 50%. In this country, banks mostly lend against existing assets, real estate assets. They lend to other

financial corporations, such as asset managers and hedge funds, which generally buy other financial assets with that money. The result is mainly asset price inflation, through rising house prices and share prices, and that does not contribute to growth and productivity.

Deregulation and the other policies that came with it, most recently the austerity policies, whereby the Government pulled back from their own capital investment, have created this situation. The reason why some other countries have not gone down that path is partially because they have major state or public banks supporting growth, playing that important countercyclical role when there is a downturn and playing a mission-oriented role by identifying key sectors that have the greatest socioeconomic benefit and investing in them at an early stage, well before the private sector feels comfortable, because there is a lot of uncertainty and it is seen as high risk.

Lord Cavendish of Furness: I would like to pursue that for the rest of the morning, but you would prefer that I did not, Chairman.

The Chairman: Exactly. It was fascinating. You have picked up a bit of what Lord Giddens is going to touch on.

Q32 **Lord Giddens:** I would like to ask two questions. First, if there is a UK investment bank, what model do you think it should follow? I am not sure that a European bank would necessarily be convincing anymore, because it has the backdrop of the EU. Presumably, we would have to look around the world. You mentioned a range of examples when you spoke earlier. One would presumably have to compare different models, pick out the best bits of them and put them together. That is my first question: is there a role model?

Secondly, the future ain't what it used to be. We are probably living through one of the biggest periods of technological change and economic innovation ever. Certainly, to me, the digital revolution is as profound as the industrial revolution and is moving much faster. Therefore, we do not have the same kind of stable investment environment that we used to have. How do you think such a bank could plan in such a context to get ahead of the innovations, rather than simply be driven by them, which in large part is the case at the moment because of the involvement of big tech companies and state-dominated tech companies elsewhere?

Laurie Macfarlane: On the first question about the model we should follow, I have spent quite a bit of time recently looking at different examples. In our most recent paper we looked at eight that are already out there in Italy, Germany, France, China, Brazil and Finland, and the EIB. We looked at a number of different design features: their mandate and mission; their investment activities; their governing structures; their technical expertise; the instruments they use; their financing model; how they balance risk and reward; links to government policy; how they interact with national accounts and state aid rules; and the monitoring and evaluation of them.

From my perspective, the key lesson is that the institutions very much play specific roles depending on the economic and industrial status of the country—the stage of development and the make-up of the economy—and there is no off-the-shelf model that you can lift and drop. For example, the KfW is often held up as the gold standard. It is a very successful institution that has been built up over a long time. There is a lot that we should learn from KfW and lots of lessons we can take away, but I would definitely caution against taking a model that is very well suited to Germany, which is a very different economy from the UK's, and trying to transplant it to the UK. That just would not work.

None the less, there are lots of lessons we can take from each of the aspects I listed. If you have any questions on specific ones, I am happy to talk about them. We could create an institution that is very much tailored and bespoke to the UK's needs and its economy, and the opportunities and challenges that lie ahead. I do not know whether you have specific questions. We probably do not have time to go through all of them right now, but I am happy to take a question on that.

Very briefly, on the point about the world changing, which is absolutely right, one of the benefits of these institutions is their ability to take a much longer-term perspective. One of the issues that afflicts parts of the corporate sector and the financial sector, not just in the UK but elsewhere, particularly in the US, is the phenomenon of short-termism—reacting to short-term incentives rather than long-term considerations. Given that these institutions are often profit-making but not profit-maximising, and instead have broader social, environmental and economic objectives, they can take a much longer perspective on where they are going and what they are trying to do. In addition, they often have significant research departments looking at exactly those kinds of things to guide and inform investment and look at the public national interest long term and strategically, rather than at where there are profit opportunities in the next two, three or four years that will maximise the shareholder return, which is often what drives some of the other institutions that make up the financial landscape in this country.

Josh Ryan-Collins: To add briefly to the second question, to get ahead of the game you need a strong industrial policy and strategy. We have seen the Government develop that, which was something of a breakthrough. You may think they could be a lot more ambitious and more money could be going into it, but at least it is there. We advised them to some extent on that. The key thing is that it is not just seen as going on over there in the business department separate from what the Treasury is doing and from what a potential state investment bank is doing. They need to be aligned and work very closely together, so that the policies identified in the industrial strategy are supported by government spending, procurement and regulation, and by the state investment bank.

As to how to design a state investment bank to be effective and at the cutting edge, you would probably want the industrial policy of the day to

be fed into its objectives, or its targets. To maintain a longer-term focus it is important that it has some independence from the Government of the day, with a governance arrangement whereby people are independent of the Government: senior executives from business, trade unions, different stakeholders across the country and, obviously, economists. The really important thing is that it is not dominated by sectoral interests. That is why the mission-oriented approach is quite important. If you make the focus of the bank—and, for that matter, the industrial policy—achieving grand challenges, whether it is reducing carbon emissions, cleaning the ocean or dealing with ageing demographics, the focus of investment should be on meeting that challenge, rather than supporting one particular sector over another. Then you are picking the willing, rather than picking winners, which is the phrase often used by people when they criticise the state investment bank model.

Baroness Neville-Rolfe: I want to come back to what Mr Macfarlane said. I will read your paper on the various banks. I have not had an opportunity to look at it, but thank you for it. I am interested in the small business side. One of the problems under the British system is that basically you have to get the money from the bank, the British Business Bank or the EIB. You are in the hands of the banks. If you are a small business with risk, it is very difficult; you have to put your house on the line. Do the other models that you have studied get around that, perhaps by having clearing houses for small businesses, so that they are getting it direct and are not in the hands of the big banks?

Laurie Macfarlane: To do business and SME lending properly and effectively, you need a local presence; you need to understand the businesses in the area. Often, state investment banks by their nature do not have the local presence and branch networks of the retail banking sector. Typically, they work with retail banks through a process called on-lending, which utilises the low financing or borrowing costs of those institutions. The EIB, or a British version, would be able to borrow at very low cost to lend to intermediaries, often but not exclusively now retail banks; some of them are working with others, such as fintechs.

They pass on the benefit of low financing costs to shift the incentives to make SME lending more attractive for the bank. Often, if the SME is higher risk and there is a large transaction cost for a relatively small loan it does not make sense for the bank to do it, so that incentive is shifted from the bank's perspective to make it more attractive for the bank to do it. It also makes the terms more attractive to borrowers, to make it more effective for them to borrow. That model is often used. The EIB uses it, as does the KfW in Germany. That is the on-lending model.

It can and does work reasonably effectively. An important question, therefore, is about the structure of the retail banking sector. What is it interested in? Obviously, Germany is very different from the UK; it has the Sparkassen, the large co-operative banking sector, which does most of that, which we do not have in the UK.

There are, however, cases where institutions try to develop capacity in-house, to have a direct line to businesses. Often there is a scale cap where institutions such as the EIB and others deal directly with firms over a certain size and work with them directly, but they will not be able to deal directly with small businesses on the basis of capacity and local presence.

A key issue to grapple with in the UK context is the relationship between a potential institution such as the EIB and SMEs up and down the country. The on-lending model is one option to look at, but it is not a simple discussion to have. There are lots of variations. Which institutions should they go through? Is it just banks? Is it others?

Q33 Lord Vaux of Harrowden: You have touched on this already. Have you identified any existing finance gaps, specific market failures, or markets that require shaping, that need to be addressed by public intervention in the UK?

Josh Ryan-Collins: Quite a lot. There is a clear SME problem, which is a financing gap that was first identified in the 1930s by the Macmillan committee. Another report, in the 1960s, reaffirmed that it was there. It is still there. It is very hard for SMEs to get financing unless they have collateral, as you suggested, with property being the preferred technique. There is also a more general gap for early-stage R&D investment. We score relatively low on that relative to the G7 and other European countries. There is a lack of what we would call patient finance. To support innovation and to get the breakthrough development you probably need quite a few failed experiments, so, because of the high levels of uncertainty, you need the patient finance that state investment banks have, historically, been very effective at providing.

Lord Desai, you are right; the UK has traditionally had quite strong capital markets, but the more general tendency in recent decades has been for the stock market to support existing companies or to be more focused on short-term returns rather than providing that sort of patient, high-risk capital. There has been a financialisation process and demand for very high short-term returns, so there are a lot of gaps. There is a gap in green investment and innovation, again because we do not have a state investment bank. Laurie probably knows about some other gaps.

Laurie Macfarlane: Josh mentioned firms and it is important to highlight what we mean when we talk about lending to firms. Often the criticism is made that it is just subsidising certain sectors or keeping struggling companies alive. There is always a risk with public institutions and public banks of falling into that trap: "Oh, they need help, we'll help them". It is not about that; it is about increasing the animal spirits of business, and helping businesses that are willing and able to make investments that otherwise would not have been made. That might mean acting on their own or acting with other investors and stakeholders to make the catalysing investment that crowds in other investment.

Josh also mentioned the green stuff. Particularly in light of the Green Investment Bank, now the Green Investment Group, there is still a role for a public body to provide some of the long-term patient finance in that area.

Another area to highlight that does not often come up is supporting exports. Each country has strict international rules that govern that, with state-backed export credit guarantees, and each country is allowed one of the institutions that provide them. They play a very important role, particularly in countries that have successfully developed strong export-led strategies.

In the UK, that is done by UK Export Finance, which historically has not done as much as it could to help firms looking to export. There have been a number of changes to support and develop that a bit, but, in comparison with what happens elsewhere, there is still a lot more we could be doing. It is interesting to note that, among other countries, moves have been made to consolidate the export credit arm within a wider state investment bank to provide a kind of one-stop shop and get synergies for providing services for businesses. We have seen that happen in France and Italy, bringing things in-house, with the state investment bank thinking more generally about how to help businesses and exports. That is another area where the UK could be doing a lot better, by bringing in UK export finance and wrapping it in a wider approach to public support.

Q34 Lord Bruce of Bennachie: You have already mentioned the recent innovations with the British Business Bank and the Green Investment Bank. Do you think that we have learned from that something that could form the basis of a bank, or banks, to support investment? In the 1980s, the then chairman of the then Highlands and Islands Development Board described it as a merchant bank with a social conscience. He maintained that it had the same rate of return as the commercial banks and the same rate of failure, but the difference was that it invested in projects that had all been turned down by the commercial banks. Are we talking about setting up a bank that will do that? Does it require some form of national consensus?

There seem to be differences of view about the role of the state in investment. We have the Scottish Investment Bank proposal, and I do not know whether you have a view on how that might work. The Labour Party immediately criticised it, saying, "They just pinched our idea, because we want a national investment bank". I do not hear the present Government talking enthusiastically about any kind of investment bank; yet, if this thing is to work, it has to be able to flow through changes of Government and circumstance. From what you have said already, we should have been doing it years ago; it is not just a Brexit thing.

You made the point about Germany. We are not Germany, but, heavens, there are things that Germany does a hell of a lot better than us. One of them is that its banks take a much more direct stake in their economy than our banks do. Is that something a national investment bank should

be prepared to do?

The Chairman: Which one of you would like to deal with that?

Laurie Macfarlane: There is quite a lot in there.

The Chairman: Keep it brief. Keep your answer focused.

Laurie Macfarlane: I shall try. There is a lot to learn from the BBB and the GIB. The process of setting them up was hugely instructive and informative in how to get such institutions off the ground. Two major things held both those institutions back and continue to do so.

First, although they are called banks, they are not banks; they are just funds that are allocated money that they are then allowed to lend and spend. They are not allowed to borrow, invest or leverage a balance sheet, as banks can in other countries. That is largely to do with our unusual and obscure public accounting rules, which we might talk about later. The BBB has quite a narrow mandate, focused on market failures and business, which boxes it in somewhat and transforms the role it can play. Those are the two things to highlight. There are important lessons to learn, but none the less the BBB and the GIB have had a positive impact.

Is it worth talking a bit about the Scottish bank? For full disclosure, Mariana Mazzucato, who is the director of our institute, is on the Scottish Government's Council of Economic Advisers, and is quite influential.

The Chairman: I think she is also on the Labour Party's council of economic advisers.

Laurie Macfarlane: Not any more.

Josh Ryan-Collins: She was.

Laurie Macfarlane: We have been liaising with the Scottish Government throughout the process of setting up the bank and looking at the role it might play in the Scottish economy. They are very much interested in the mission-oriented role we talked about. An implementation plan was published in February, and we are now in the process of going through it and setting the thing up, and we hope that it will be operational by 2019.

On the question of how a Scottish bank would interact with a UK one, it is very common to have something like that. We already have it. In Europe, there is the EIB and the national institutions, and in the UK we would have a UK one and a Scottish one, because there are different policy priorities for different Governments. The Scottish Government have different policy objectives, particularly in relation to climate and environment, place-making and local development and demographic challenges. Those are the key focuses of the mission of the new bank, and they are very much tailored to the Scottish economy. A UK version would focus on UK policy priorities, which will be slightly different. I can go into more detail on that if you like, but I thought it was worth flagging

up quickly that we have been involved in it. Do you want to pick up the government consensus point, Josh?

Josh Ryan-Collins: A Government of any political preference would support an institution that enabled a large amount of spending, particularly if that spending did not count against the deficit. It is probably worth discussing the accounting issues around that. On Germany—

The Chairman: One of our later questions will deal with that, so perhaps to make a bit of progress we should reserve that thought for that question. Is that agreeable to the Committee? Were you done, Lord Bruce?

Lord Bruce of Bennachie: I do not know whether Mr Ryan-Collins has finished.

Josh Ryan-Collins: I was just going to answer your final point about taking a stake in a business. The German regional co-operative banks tend to do that. A state investment bank could provide equity and require a return on it. A lot of state investment banks clean their backs; they never get into debt and they are very profitable. The EIB has been extremely profitable. It should not be seen as another cost for the Government; it should be seen as an institution that will create assets, which themselves provide a flow of income to UK plc.

Q35 **Lord Cavendish of Furness:** There may need to be some repetition. There are different ways that state investment banks can finance their operations. Based on your research of the existing models, how do you think a UK institution should finance itself, and how would that compare with how the British Business Bank finances itself?

What are the benefits of having a state investment bank that can borrow on the financial markets, and what are the risks of them doing so? Finally, to pursue a hobby-horse of my own, have you ever considered the question of finance by project bonds?

Laurie Macfarlane: Internationally, there are many different ways for the institutions to finance themselves, ranging from issuing bonds on capital markets, which is most common in Europe, to managing some kind of social security fund, as is the case in Brazil. In Italy, the Cassa depositi e prestiti is responsible for managing the country's postal savings, which have been a historical source of household saving. In China, there is direct co-ordination with the central bank.

In the UK context, my recommendation would be that, primarily, the bank should be capitalised by government but would then be able to issue bonds. It should have a strong credit rating, being backed by the UK Government, and be able to finance itself that way. That is not what happens with the BBB, for example, which is a crucial difference. The benefits of that come down to the magic of leverage; you get more bang for your buck. For example, for every pound or euro that member states put in to capitalise the EIB, two and a half pounds or euros of investment

are made. That is because the EIB is allowed to leverage its balance sheet two and a half times. That is a rule; it cannot go beyond that, and it is very conservative. Many other institutions go further than that. As bang for their buck, a Government will know that they can put in £1 of capitalisation and leverage it up to invest, which increases their firepower considerably.

Obviously, as with any kind of borrowing, there are risks that need to be managed. You should borrow prudently, because there is always a risk that you could go into debt, but relative to the private banks, the leverage that these institutions take out is very low. I would certainly recommend, at least over the medium term, that an institution should try to do that, pending public accounting rules, which we may come to later.

Josh Ryan-Collins: You mentioned project bond financing, Lord Cavendish. That is where the bank would issue a bond to fund a specific infrastructure project, so it is capital market financing, essentially.

Lord Cavendish of Furness: That is what I had in mind: a Victorian model.

Josh Ryan-Collins: Yes. I think that makes sense. We need to view infrastructure, such as housing, in that way. Quite often the value of the land where you are going to create the project goes up, and we need to think about capturing that value publicly.

The Chairman: With a land value tax.

Josh Ryan-Collins: Yes. You can also finance a project on the basis of the perceived future rises in the value of the land. That should make project bond financing appealing.

Q36 **Lord De Mauley:** I have a couple of questions. First, if you were designing a UK state investment bank, what design features would you put in place—for example, to address governance and the balance between risk and reward? The second question is related to that but is the other side of the coin. A concern that we have discussed is that those responsible for investment in a state investment entity in a country such as ours may often in practice feel heavily constrained from taking risks, which is precisely what we want them to do. How do you deal with that?

Laurie Macfarlane: We touched on some of the design features around what the bank's mandate should be set up to do. We are very much of the view that it should be set up with a specific mission or challenge-led approach, rather than the static approach that it should exist to promote economic growth or support development. Rather than something that is quite static, it should give a sense of directionality aligned with wider government priorities.

Governance is one of the most important design aspects, and it is where public financial institutions around the world have often gone wrong. It is about striking the right balance of political representation. On the one hand, you want some sense of democratic accountability while being able

to align with government priorities, but, on the other hand, you want to make absolutely sure that it is not run or swayed by day-to-day political interests, and that it is free to make independent banking decisions based on sound financial principles. That is a really important part, and it should be considered very carefully. We should learn from best practice around the world and from examples where it has not worked particularly well. It can involve multiple layers of different types of boards with different layers of accountability, ultimately leading to the Government as owner, but making sure that there are appropriate checks.

Lord De Mauley: Is there a model that would work for this country, in your view?

Laurie Macfarlane: The best model in my view is the KfW one, which, interestingly, is slightly different in that as well as having some political representation it has expert representation from finance. It also has representation from wider German society; different stakeholder bodies have a say and a seat on some boards, and have input. That is quite an important part of building the consensus-type approach. It is a big tent approach and it is not seen as specifically to do with one party. You do not want a governance structure dominated by one political party, for example. There are lots of lessons to learn from the German example, and the Scandinavian one: the Nordic Investment Bank and Finnvera in Finland are quite similar. In my view, they are the gold standard to learn from.

We have talked about sources of finance. Another interesting thing that we have not talked about is what instruments the institution would use, such as debt equity appropriate for different types of landscape. That is very important with regard to the kind of role it will play, particularly the venture capital, innovation and mission-oriented role.

On the approach to risk and reward, one benefit of having an institution that has its own balance sheet rather than just doing everything through central government is that you have the discipline of managing a balance sheet in itself, but you can also structure a portfolio of investments across the risk-reward spectrum, making sure that the higher-risk ones are offset by lower-risk ones. The key to that is making sure that you can capture the upside of the investments you are making. It is not government spending; it is not about the Government giving out grants all the time. It is about investing and earning a return, whether in interest, dividends or capital gains through equity. That is quite important.

Josh has already mentioned broader alignment with the state investment bank. It is important that it is aligned more broadly with other parts of government policy, rather than operating out of sync or out of cycle with what other institutions and government policies are doing.

Josh Ryan-Collins: Another key point on governance and consensus building is that the bank should support the UK regions. One of the biggest issues we have is lack of investment in specific regions,

particularly the north and Wales. Having representation from the regions on the board would be important, and it might be a way to make it more popular across the parties.

Q37 Baroness Liddell of Coatdyke: The clock is ticking; we are in the final quarter of 2018. In reply to Lord Desai, you referred to the expertise and capability available in the EIB. What possibility is there of getting the necessary scale and expertise before December 2020? Do you think there might be a financing gap when we lose access to EIB funds, and how would you address that in the interim?

Laurie Macfarlane: Doing it by 2020 would be difficult. It would certainly be challenging. That is very soon. Our experience of setting up the BBB and the GIB shows that it can take about two years for such institutions to get from start to end. An important part of the process thus far has been getting state aid approval from the European Commission. Obviously, there is a question mark about whether or not that will be easier and, if so, what the process will look like. Time is an important part of the consideration with that type of institution. If the Government are thinking about doing this, they should really be cracking on with it, because getting it done by December 2020 will be very tight; steps need to be taken right now.

You asked whether there would be a gap. Some specific sectors that benefited more from EIB financing will be hit more than others. As an interim step, there are options that the Treasury can take, such as expanding the remit of the British Business Bank, which already exists, while a longer-term option is developed.

Lastly, and very briefly, it is important to highlight that these types of institutions, or at least the successful ones, do not appear overnight. We would aim to get one up and running, I hope, within two years, but that would be a starting point; it would not necessarily be the full all-singing all-dancing thing that we might hope to end up with. The successful ones around the world have often been around a long time and have grown and evolved substantially over that period. Obviously we hope to learn from that, but it takes time, particularly as capacity and expertise is an issue in the UK, having not had much of that type of stuff in the past.

Q38 The Earl of Lindsay: Are you convinced that having a single state investment bank is the right solution? We heard from another witness that a preferable format would be a number of entities or schemes targeting specific objectives, such as exports, SMEs, education, utilities and so forth.

Laurie Macfarlane: That is an interesting area. The first thing to highlight is that institutions that are one institution are almost always structured in such a way that arms or parts of them focus on different things. For example, there is an arm of the KfW for SME financing and supporting the Mittelstand in Germany. There is another arm for infrastructure and that kind of thing, and another for export stuff, the IPEX-Bank, which is within the KfW umbrella. At KfW, they have created

a brand-new VC arm, to scale up VC activities. They are all under the broad KfW umbrella, although they operate independently.

There is an option to carve those out as separate things. As I said, the recent trend has been the process in reverse: places that have had separate entities have decided to bring them all in-house, to take advantage of staff and expertise synergies, creating a more coherent landscape for businesses. There are benefits in having a single entity and a single brand, but, within that, specialised departments and arms to deal with different types of customers, to benefit from the synergies that brings.

The Earl of Lindsay: A related question is whether you could ever contemplate a landscape where multiple state investment institutes were operating within the same economy or nation, offering different priorities.

Josh Ryan-Collins: That is the Chinese model. They have a number of very large banks, one focused on construction, one on technology and one on export, and a very large agricultural bank. There are probably other countries with similar models. From a UK perspective, given that we do not have any of that, there is an advantage to having it centred in one institution, initially at least, sharing knowledge and developing expertise within one institution, and working closely with the Treasury and BEIS on industrial policy, and maybe at a later stage splitting it. That would be my inclination.

Another point relates to the UK banking sector itself, and the problems there. We have a highly homogenous banking system, dominated by one particular model, the shareholder-owned model driven by short-term returns, mainly focused on property or real estate lending—loans that they can collateralise—and less focused on relationship lending, whereby they de-risk a loan by building a relationship with a business over time. There is a need for an institution that can support that kind of relationship lending.

One proposal is to break up RBS to create multiple, more regionally oriented banks, which could potentially be a complement to a state investment bank. A state investment bank on the KfW model could offer to subsidise retail banks, making specific types of productive lending to SMEs, for example. That would be another way to try to hit both those goals with one institution.

The Earl of Lindsay: I have a final question on the landscape. Are you convinced that it is better that this sort of lending is done by an arm's-length stand-alone entity or entities, rather than government schemes, which may already be up and running, and could therefore be more quickly and easily ramped up to deliver against a 2020 deadline?

Laurie Macfarlane: There are broadly four benefits to having an institution as opposed to having the Treasury do it. There is a lot of value in building an institutional hub of expertise in important areas of investment and finance in the public sector that is independent and

distinct, with its own identity, from, for example, government departments. An arm's-length institution can be free from the day-to-day political mood music of the day that tends to consume the Treasury and other departments; it is a stand-alone entity that can take time to review and focus on its strategic priorities, free from the noise of day-to-day politics, which can often be very distracting.

I have already mentioned the benefits of managing a balance sheet as an institution, which is important and is very different from what the Treasury does, which is to manage tax and spend. That is very important, but it is different from managing the balance sheet of a financial institution, which is primarily borrowing and investing. One reason why it is attractive in other countries is, partly, because it does not cloud the debate on the debt and deficit stuff, as it does in the UK, because of the rules that we will go on to talk about. That is an issue in some countries; it is a way of carving out the long-term investment stuff from the day-to-day tax and spend stuff.

The Chairman: Lord Butler will ask about tax and spend and balance sheets.

Q39 Lord Butler of Brockwell: First, can we return to an issue that we touched on earlier? Do you envisage that a new UK financing institution would feature as part of the public sector net debt? Is there any escape from that? We understand that the KfW does not do so in Germany. What are the features that enable it not to appear on the national measure of debt?

Laurie Macfarlane: It comes down to the measure of debt and deficit that countries decide to use for their official statistics and fiscal targets. In the UK, the measures we use are public sector net debt and public sector net borrowing. They are the official figures. They are everything the Treasury bases its forecasts and targets on, and they include central government, local government and public corporations; all the liabilities of all those different things count on the debt and deficit. The UK is unusual in that approach; it is a complete outlier internationally. It is a measure that only the UK uses, which we have come up with and imposed on ourselves.

Elsewhere and across Europe, the measure used is something called the general government gross debt. That is the measure you have to report for the Maastricht criteria. It counts the liabilities of central government and local government but, crucially, not public corporations. There is a kind of logic to that because public corporations operate at arm's length and often on a commercial basis. Yes, they have liabilities, but they also have assets. They are often profit-making; they are not a cost. It keeps them separate from clouding decisions on tax and spend, and the sustainability of that.

The difference between the two measures becomes particularly striking when we consider state investment banks. In Germany, the KfW is vast, with a balance sheet of about £0.5 trillion. Germany has a reputation for

being fiscally prudent; its debt to GDP ratio is about 71%. It has a hard-nosed reputation. If you calculated all of Europe's debt on the basis that we have decided to calculate it here, Germany would be one of the most indebted countries in Europe, behind Greece, once you counted the liabilities of the KfW, the Sparkassen and Landesbanken, and the extensive public banking sector.

Although it sounds like a technical thing, the approach we take drives political behaviour. With the Green Investment Bank, for example, George Osborne said, "Yes, maybe it will be allowed to become a proper bank and borrow, but not until the debt-GDP ratio falls", which of course it never did. That ended up being one of the reasons why it was privatised. Because we are an outlier and because this is something that has not been imposed on us by anyone, but which we have imposed on ourselves and which we can change, it is worth looking at.

We have changed it before, regularly. After the financial crisis we bailed out the banks and we decided to change the measure to public sector net debt ex, specifically to exclude RBS and Lloyds. It is flexible and it can change. To bring us into line with international norms would make a lot of sense technically, but it would also very much help politically. It would keep the debate around public debt and tax and spend separate from this kind of stuff.

Lord Butler of Brockwell: I take it that, in the last resort, the German Government stand behind KfW so that if it went pear-shaped they would have to bail it out.

Laurie Macfarlane: Yes. In Germany, the Government stand behind the KfW. They are the majority shareholder and own the capital base, so it is recorded as a contingent liability in the accounts, rather than an actual liability on government accounts.

The Chairman: Did you want to come in, Lord Cavendish?

Lord Cavendish of Furness: Yes, but on an earlier point. Perhaps I can do it in the wind-up.

Q40 **Baroness Neville-Rolfe:** Another potential obstacle to creating our own UK institution has already been touched on: the existing or future state aid rules that we might sign up to in any agreement. How have other EU countries got around the state aid rules in establishing banks? You mentioned the KfW. Does that limit the scale of bank that we could contemplate, if we wanted to go down that road?

Laurie Macfarlane: The regime of state aid today is managed by the European Commission and is an important consideration in setting up these institutions. State aid rules prevent Governments from providing an unfair advantage to certain entities over others and to certain competition. A number of criteria mean that you are either exempt from state aid rules or they do not apply. The first is the market economy operator principle, which applies if it is a public body but operates purely commercially and does not do anything that others could not do. There

are instances of state investment banks where commercial activities are distinguished from promotional activities, as they are sometimes called—promotional activities being state aid. That is a large part of what state investment banks do, but there are also activities done on a commercial basis.

Importantly, however, there is a large number of general block exemptions in the state aid regime in the EU. There are a whole bunch of areas that, for whatever reason, are subject to either strategic priorities for the EU or known market failures and are therefore exempt; they have quite significant exemptions from state aid rules and include regional aid, support for SMEs, risk finance, innovation, research and development and huge amounts of state aid on the environment. That area is often where those institutions operate.

State aid rules are an issue and prevent institutions doing lots of things, but in the areas where a lot of them operate they allow institutions to operate within the framework of the current guidelines. In the UK, we have often massively underused the allowed state aid compared with other northern European countries. Our state aid expenditure is hardly anything compared with the Scandinavians and Germans. We have taken an overly cautious approach, which again we have imposed on ourselves; we have decided just not to do things, even though we could. There is quite a lot more that we could be doing, even within the current rules. It is an important consideration, but it cannot be used as an excuse for inaction.

Baroness Neville-Rolfe: You are saying that we could have a bank of significant size. Can I press you on the regional aid point? I found it quite surprising that, basically, anything could be regional aid. Is the criterion that it is regional investment? You could help out the north-east by giving loans to car manufacturers.

Laurie Macfarlane: I do not know the specific criteria. Under each of the broad headings, or the buckets such things go into, there are sub-things that are quite specific about what you can and cannot do. Clearly, a remit of a lot of these institutions, including the EIB, which is also subject to the state aid regime, is specifically around regional development. Again, the KfW has been hugely important in redeveloping East Germany and supporting areas that are lagging behind. I can look into it for you. I do not know the specific criteria, but an important part of the exemptions to state aid is on regional support and development, bringing support and convergence for structurally weak regions of the economy.

Baroness Neville-Rolfe: If you could share your expertise in that area, it would be enormously helpful, because agreements, whatever their nature, tend to have clauses linked to state aid, so to understand how constraining they are would be extremely useful.

Q41 **Lord Cavendish of Furness:** I turn to an anxiety that Baroness Neville-Rolfe expressed earlier about the SME sector. I declare an interest as it is a sector I belong to. It represents some 95% of economic activity. I

particularly want to home in on the cyclical point.

I am just old enough to remember sectoral banks, with their detailed knowledge. We are planning soon to leave the CAP, and I cannot see how any of your models could understand those highly complex sectors. I know from my own experience that the man in the high street does not understand that a potato grower makes his money every seven or eight years, or whatever it is. It is a very complex system, yet there is a vast amount of money in the whole. Are you convinced that your models address that sectoral point?

Laurie Macfarlane: Do you mean specifically in relation to agriculture?

Lord Cavendish of Furness: Agriculture would be a good example, particularly as we are going to leave the CAP. An enormous sector is going to suddenly find itself trying to rediscover its own markets.

Laurie Macfarlane: In what we have described and looked at in the context of the UK, we have not been looking specifically at agriculture. CAP and what happens to it is a huge issue, and frankly I do not have the expertise or the answers to that. None the less, I do not think it is outwith possibility. You can develop specific expertise in the areas where these institutions invest, and employ not just finance people but people who understand and work in the area, whether it is a scientific area, engineering or whatever. That is demonstrably something that these institutions do.

As Josh mentioned, some countries with a large agriculture sector with specific challenges have specific agricultural banks, and they often have a local branch presence in their rural areas. I will have to defer on whether that is an important area for the UK to look at post CAP as agriculture is not my area of expertise, but the point about expertise is as relevant for that sector as for any other.

The Chairman: Can I take you on a bit? You have both forcefully expressed a view that a single national promotional bank with sectoral expertise and an ability to lend across different sectors and so on would be the way forward, and you have given us fantastic evidence in that regard. What we are missing is what happens to the British Business Bank and the Green Investment Group, since they already exist, in the new architecture you think we ought to set up. What would happen to the BBB if we set up a single entity to replace the EIB?

Josh Ryan-Collins: My recommendation would be that those two institutions and, potentially, a number of other public credit schemes—

The Chairman: Such as the government guarantee scheme.

Josh Ryan-Collins: Yes, there is a whole range of credits for SMEs and various other schemes. It is actually quite time-consuming for small businesses to work out where they all are in the government apparatus. I would suggest that they are all brought together under the umbrella of

that one institution, so that there is a one-stop shop effect, which businesses would much prefer.

As Laurie was saying, the BBB is not really a bank; it cannot borrow on capital markets. The bank we are talking about would be a much bigger institution, which should have much larger capitalisation, closer to the size of the KfW. It would be a completely different type of organisation and should be allowed to borrow on capital markets. In that sense, it would be on a much bigger scale.

Laurie Macfarlane: I mentioned earlier what has happened in Scotland, where they have grappled with the same considerations and problems, albeit on a smaller scale. The Scottish Government, in addition to UK Government schemes, have an array of different things that have been introduced over the years, such as the Scottish Futures Trust and something called the Scottish Investment Bank—confusingly, because it is not a bank but part of Scottish Enterprise.

Part of the process was decluttering the landscape, providing a much more coherent approach for business and other types of customers. There is a benefit to that in and of itself because, in a situation where lots of ad hoc things have been introduced over the years for different reasons, there is an opportunity to look closely at them and ask whether they make sense. Something might have been introduced by a Minister for a reason that does not really exist anymore. You can take a stock check and design things accordingly. With Brexit, there is an ideal opportunity to do that.

The Chairman: Thank you very much. If you come up with any supplementary thoughts that might illustrate some of the points you have made, that would be fantastic. Thank you for your time.