The Good Jobs
Taskforce

economics as if people and the planet mattered

The British Business Bank

Creating good sustainable jobs

This report and the Good Jobs Taskforce

This report contains recommendations for a state owned business bank from the Good Jobs Taskforce. It starts by looking at the Government's current plans for such a bank and builds on ideas from several other reports. It has been prepared by staff at **nef** (the new economics foundation) and has been informed by discussions with members of the Good Jobs Taskforce and at an external round table.

The Good Jobs Taskforce consists of representatives of business, the trade union movement, academia and think tanks (the members are listed below). While the key recommendations in the report were supported at the most recent meeting of the Taskforce, the report does not represent the views of individual members of the Taskforce or their organisations.

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Executive summary

This report builds on the Government's current thinking for a British Business Bank (BBB) and draws on reports from other think tanks. It is agreed that such a bank must address a lack of investment in SMEs (Chapter 1), but we also ask:

- what should the bank's mandate be? Could it solve other problems, and if so, what?
- how should this mandate be put into operation?
- and how can the bank distribute its products and services so that it serves the whole country – including the parts that need it most?

The mandate of the bank

Many publicly owned banks overseas have broader mandates than lending to SMEs (see Table 1 on page 11), and we argue that the BBB's mandate should include supporting an industrial strategy to deliver good, sustainable jobs (Chapter 2). An industrial strategy is needed because there are too few good jobs in the UK economy, for both graduates and non-graduates. In addition, the transition to a sustainable economy – one with businesses that can survive and thrive in a world where externalities are priced and regulated – is too slow.

The bank should be part of delivering this strategy because it can:

- incentivise business to align with the strategy
- send a strong message about the government's commitment to the strategy
- help co-ordinate finance and other forms of business support
- internalise externalities
- and feedback from the front line into the strategic process.

Measuring success

Short and long-term outcome indicators should be used to monitor performance for each region of the bank and the bank as a whole (Chapter 3). Short-term indicators should measure the bank's contribution to increasing employment, median earnings and job quality and reducing carbon emissions. Long-term indicators should cover how the bank contributes to regional and national industrial strategies and might include measures of employment, skills development and environmental efficiency. Some investment in data collection is required. This must be made by government and not by investee firms: the bank's processes cannot burden customers.

The bank's board should set a small number of targets for management based on these indicators, with regional targets based on similar regional indicators. Regional boards may need limited flexibility to prioritise different aspects of the performance framework.

The bank's products and processes

Management should have discretion over products, processes and the way the bank works with other public agencies, but we offer examples the bank could use to reach targets, including some used by banks overseas (Chapter 4).

The bank could also offer or provide access to additional support services and become a source of business advice and expertise.

Distribution

Our research showed that some state owned banks have a large network of branches and distribute directly to business (Chapter 5). Others work through third parties. However the latter operate where there are thriving local banking networks such as the German Sparkassen, with good branch relationships with local businesses. This represents a dilemma for the UK: on the one hand, setting up a network will be expensive and take time; on the other we do not have a network of local banks. Indeed one of the main problems we are trying to solve is precisely the lack of investment by the commercial networks in local capability. Thus there are two options: the bank must establish its own branch network, or the government must stimulate the UK local banking sector. There are three ways it can do this:

1. continue to scale up the UK's nascent community finance sector

2. design regulatory incentives and structures to encourage the establishment of new local challenger banks

3. convert the UK retail banking operation of RBS into a network of independent local banks with shared services and systems, comparable to the German Sparkassen.

These three options are not mutually exclusive, but restructuring RBS is the one that is most likely to transform the local banking infrastructure at speed and scale.

Working with other agencies

Whichever distribution model the bank adopts, it will need regional offices to ensure it contributes to the development of regional and local industrial strategies (Chapter 6). Regional offices would also allow regional boards to set effective targets.

The bank should work with local enterprise partnerships (LEPs) on regional and local industrial strategies (with government stepping in if there is disagreement). It should work with government, other public agencies, business and the trade unions on national industrial strategy. It could also administer government business grant schemes for a fee.

Governance

Government should be the sole ordinary shareholder. The bank's mandate and performance measurement framework should be embedded in its constitution and legislation. Government should exercise control through a 'Board of Governors' (Chapter 6), which would appoint and set targets for management but with limited power to instruct management.

Board members should include representatives of the regional boards, ministers, opposition politicians and independent banking professionals. There should be at least one staff representative, preferably appointed through the trade unions.

Regional boards should agree regional outcome targets with the Board of Governors and local agencies, and be responsible for reviewing their progress. They should include politicians and representatives from LEPs, banking, staff, head office, and other agencies.

Representatives of business, the trade union movement and academia should join an advisory board. Parliament should also set up a select committee with powers to question the bank's governors and management, and to make recommendations.

Conformity with rules

National accounting rules may need to be amended in line with international practice to allow the bank to operate effectively (Chapter 6). It should not be difficult to conform to EU State Aid rules, but more detailed work is needed.

1. A British Business Bank

The major political parties agree Britain needs a national investment bank to address market failures in the supply of capital to small and medium sized enterprises (SMEs).

But important questions remain unanswered. Beyond lending to SMEs, what should the mandate of such a bank be? How can this mandate be put into operation? How should it be structured to benefit all regions? And how can it work with other agencies to deliver an effective industrial strategy?

The thinking so far and why this report is needed

This report addresses these questions. We argue that such a bank can be integral to delivering an industrial strategy that is designed to deliver good, sustainable jobs. And we demonstrate how the bank can do this while maintaining its commercial viability.

In this chapter we summarise current thinking – from government, other think tanks and reviews – and present the unresolved issues that we address in this report.

1.1 Recent work

For many years there has been considerable discussion about SME financing. Over the last two years several proposals for a publicly owned investment or business bank have been published, including:

- Robert Skidelsky, Felix Martin and Christian Wigstrom's *Blueprint for a British Investment Bank* (November 2011)[1]
- David Merlin-Jones' *Extending Lending: The Case for a State-backed Investment Bank* (Feb 2012) published by Civitas[2]
- Nick Tott's *Case for a British Investment Bank* (June 2012)published as part of the Labour Party's policy review[3]
- Tony Dolphin and David Nash's *Investing for the Future: Why we need a British Investment Bank* (September 2012) published by the IPPR[4]
- The British Chamber of Commerce's *Case for a British Business Bank* (September 2012)[5]
- The Department for Business, Innovation and Skills' (BIS's) *Building the Business Bank: Strategy Update* (March 2013) containing the most recent account of the Government's evolving proposals.[6]

Related proposals have been made in papers from the IPPR (which build on Dolphin and Nash's September 2012 paper) and the Labour Party's policy review:

- The Northern Economic Futures Commission's *Northern Prosperity is National Prosperity: A strategy for revitalising the UK economy* (November 2012) published by IPPR North and which builds on Dolphin and Nash[7]
- Ed Cox and Katie Schmuecker's *Beyond Big Banks and Big Government: Strategies for local authorities to promote investment* (March 2013)published by the IPPR[8]
- The Small Business Taskforce's *An Enterprising Nation* (March 2013) published as part of the Labour party's policy review.

Meanwhile, the Green Investment Bank (GIB) was granted State Aid approval by the European Commisison in October 2012, and is now operational.

In the next section we summarise the problems these reports identify. The solutions they propose appear in the boxes.

1.2 Problems these proposals aim to solve

All the proposals above – apart from the Green Investment Bank – address failures in the market for business finance. (Skidelsky suggests a bank could also be used as a counter-cyclical, reflationary tool but this is not explored by others). Failures affecting SMEs include:

- the 'Macmillan Gap' between banks and industry. Information failures and high transaction costs either raise the cost of finance for SMEs, or make it unavailable to those without collateral. This gap was first identified by the 'Macmillan Committee' in its report published in 1931 (Skidelsky, Tott, Dolphin and Nash, Northern Economic Futures Commission, Small Business Taskforce)
- the Macmillan Gap widening in recent years as banks move towards higher margin trading and commission based activities, and away from lending (Dolphin and Nash). Banks now lack local staff who can make sound discretionary lending decisions to small businesses (Small Business Taskforce)
- the Macmillan Gap widening because of the crash, leading to tougher capital requirements and a lack of confidence in the banking sector (Skidelsky, Dolphin and Nash), and the likely future impact of international banking regulations (Basel III) on exposure to the SME sector (Dolphin and Nash)
- short-termism among private sector finance providers, or a lack of 'patient capital' (Skidelsky, Tott, Small Business Taskforce) and excessive reliance on overdrafts (Tott)
- lack of competition – five banks account for 90 per cent of SME accounts (BIS), with limited alternatives to traditional bank lending (Tott). This results in an over-centralised, homogenous system and poor service (Small Business Taskforce)
- an equity gap for modest amounts (Tott, Dolphin and Nash). Britain has a small number of 'angels' compared to the US (Small Business Taskforce). This presents particular difficulties in the £500,000 to £2m range, where amounts are too much to raise informally but too small for institutional investors (Dolphin and Nash)
- a shortage of mezzanine financing (Small Business Taskforce, BIS)
- in the north of England, a historic reliance on public sector sources of finance, which are now drying up (Northern Economic Futures Commission).

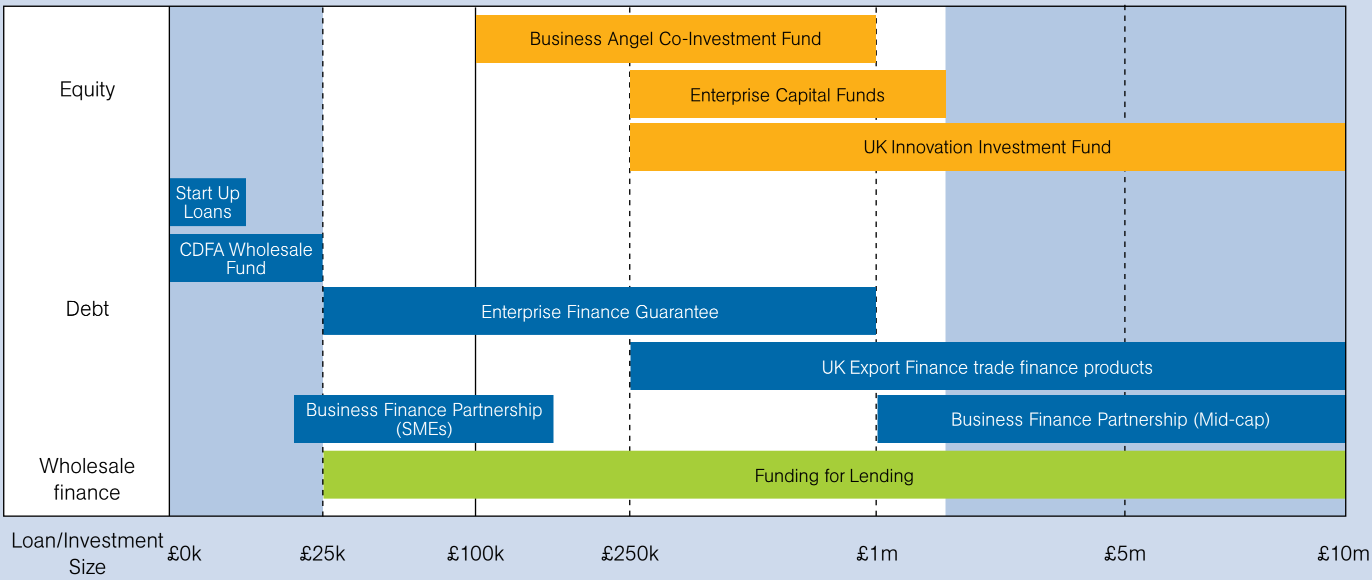
BIS suggests these failures particularly impact four types of business:

- SMEs of all sizes seeking finance to expand or develop new products and services
- SMEs who lack collateral to take out a secured loan
- SMEs at the smaller end of the SME scale
- SMEs that have existed for fewer than five years.

Some proposals also identified a failure to invest in infrastructure. This is more of a government than market failure – although reasons why the private sector does not step into the breach are given. Skidelsky quotes an estimate from the Institute of Directors that there will be a £500bn shortfall in public investment in infrastructure over the next ten years. Tott refers to public sector investment cuts, and Dophin and Nash describe the low priority given to capital spending by governments throughout the post-war period. The Northern Economic Futures Commission reports the problem is particularly acute in the north of England.

The Green Investment Bank aims to remedy a shortage of private sector investment in green infrastructure and other assets (but not innovation, which is the responsibility of the Technology Strategy Board) by providing expertise that is lacking in the market.

Figure 1. Existing government inverventions



Finally, Skidelsky refers to the inability of the private sector to invest for general societal advantage.[9] The Small Business Taskforce identifies two examples of this: returns to early stage venture capital are low or zero on average so cannot attract private finance – even though this kind of investment can generate significant returns to society; and venture capital managers favour capital intensive rather than labour intensive businesses, reducing the potential to create jobs even in schemes supported by the Government.

Many government schemes already address these problems, with varying degrees of success. The main interventions are set out in Figure 1 (from BIS). The shaded areas represent the loan or investment sizes where BIS recognises problems.

The consensus is these schemes do not deal with all the problems described and that it would be better to consolidate them into a new institution.

BOX 1: The Government's plans

BIS is setting up a business bank, to be fully operational by the second half of 2014, that will:

- increase finance to viable but under-served businesses – especially long-term finance
- increase the diversity of suppliers and products in the SME and mid-cap finance market
- promote Government finance and other support by consolidating existing schemes.

The business bank will not invest in or lend to business directly but increase the capacity of existing channels of finance, by reducing risk and increasing the profitability of investment. These channels include debt, equity and mezzanine finance and most of the schemes in the diagram above.

There will be some immediate refinements and a small amount of new money, while plans are being developed for new mezzanine and long-term debt products for SMEs. Wholesale products are also being developed, to reduce risk or the amount of capital a lender needs to hold against a portfolio of SME loans. The bank may also offer business advice.

It will have £1bn of new capital and will take over existing investments, giving it a total of £3-4 billion. It is expected to produce an 'appropriate' return.

The Business Bank will be separate from the Green Investment Bank, which aims to accelerate the UK's transition to a green economy by co-investing (with the private sector) in projects such as offshore wind, waste recycling, waste energy, non-domestic energy efficiency and the government's Green Deal.

BOX 2: IPPR proposals

Of proposals from outside government, this has the most developed recommendations, drawing lessons from publicly owned investment banks including: KfW (Germany); BNDES (Brazil); the US Small Business Administration; the European Investment Bank; and the Nordic Investment Bank (though evidence on the latter two draws heavily on research undertaken by Skidelsky et al, 2011).

The proposed bank would be fully state owned. It would not maximise profits but it would have targets for profits, which would build reserves rather than pay dividends. Its remit would be to invest in SMEs and income-generating infrastructure.* These may look like different functions, but the authors argue other national investment banks (such as BNDES) combine them successfully to create a diverse portfolio.

Apart from this, the bank would not have a detailed mandate. It would not target regional growth rates, levels of regional lending or the most deprived areas, so as to avoid subsidising fundamentally unviable businesses.

The bank would provide both debt and equity, and also act as an advisor, for example by identifying viable projects for others to finance. It could be the sole investor or a co-investor and could guarantee the riskiest part of lending (by creating tranche structures and then providing or buying risk in the most junior part).

The IPPR recommends that the bank set up its own regional network or invite tenders from banks and/or other organisations to be regional agents or loan officers. Local knowledge is important for SME financing. It might also distribute SME loans through other banks, community development finance institutions (CDFIs) and credit unions. The distributor banks would take say 20% of the credit risk to avoid adverse selection. In addition it could lend to commercial banks in order to increase their lending to SMEs (a variation on the Funding for Lending scheme).

As for the quantity of investment, the authors believe it is impossible to make a definite forecast, but suggest increasing the balance sheet by £25bn a year – with a view to stabilising it after four years at £100bn. The authors propose a total of £40bn subscribed capital, of which as little as 6% might need to be paid-in by government (that is £2.4bn, or £0.6bn a year as the bank builds up its balance sheet). The rest would come from the capital markets.

There would be no explicit government guarantee on these bonds, so they would yield a bit more than gilts but less than corporate bonds. The bank's financial liabilities would count towards public sector net debt, but the bulk of its assets would not be netted off. The authors propose that the UK's fiscal position should be measured by the same standards as those used in other Organisation for Economic Co-operation and Development (OECD) and EU countries (which exclude public sector enterprises).

The bank might securitise and sell on bundles of its SME loans and perhaps facilitate a private placement market. It would be commercial and independent of government, but as sole shareholder, the Government would set the strategic objectives.

The following structures would be put in place:

- a board of governors, to include government ministers, who would set objectives and appoint senior executives, but who could not interfere with day-to-day management
- a supervisory board to review performance against these objectives, consisting of a cross-party group of politicians, like the Treasury Select Committee
- an advisory council to make recommendations to the board of governors, which would include ministers, MPs, civil servants, and representatives of devolved regions
- technical advisory groups on specific issues, such as green energy
- an executive board consisting of senior management.

The bank would need to show it was not just undercutting commercial banks and that it satisfied the EU market failure criterion, so that it could secure EU state aid approval.

Under the IPPR's proposals, the bank's investment capacity would be considerably greater than that of the Green Investment Bank (GIB). The authors suggest the GIB could continue as a standalone institution, or be absorbed into the bank's infrastructure arm. The bank would then take over the GIB's green mandate or support investment in a low carbon economy in other ways.

The IPPR's Northern Economic Futures Commission report builds on this. It recommends ring-fencing funds for investment in the North of England (and other regions), using a formula that includes population and 'economic potential' to set amounts. It proposes a governance structure that allows northern leaders to set additional high-level strategic funding priorities, for example to support particular infrastructure or supply chain development.

Cox and Schuemecker's report suggests local authorities complement a national investment bank by making more use of the municipal bond market to raise funds for infrastructure and to on-lend to smaller projects. Local authorities should also consider working with each other to create cost-effective pooled bond issues.

* The British Chambers of Commerce argues that there should be two separate institutions for infrastructure and business banking – with the Green Investment Bank possibly taking on additional infrastructure investment. Civitas also suggests keeping the enterprise bank separate from the Green Investment Bank.

BOX 3: Small Business Taskforce proposals

The Small Business Taskforce's proposals for improving provision of finance to SMEs include:

- modifications to the debt and equity programmes envisaged for the business bank – in effect detailed product recommendations for a British Investment Bank (BIB)
- creating new local solutions for small business finance to work in partnership with a BIB, inspired by the Sparkassen – the local banks in Germany which only operate in their designated geography
- steps to encourage other new entrants into the banking and business lending market
- steps to encourage initial public offerings (IPOs) of growth businesses by creating a UK rival to NASDAQ
- various changes to the tax regime to encourage investment.

We summarise the first two of these here as they are directly relevant to this paper.

Products
The Enterprise Finance Guarantee Scheme (one of the Business Bank's programmes) should be more like the US Small Business Administration (SBA) lending programmes. In particular, the term 'viable' should be redefined using similar criteria to the SBA's. This would allow a wider range of loans to be supported.

At the same time the Enterprise Capital Fund (a business bank equity programme) could be modified to include a mezzanine finance programme similar to that of the US Small Business Investment Corporation. The Enterprise Capital Fund could also allow the government's tranche to be subordinated to private sector investment, in return for higher returns if the investment is successful. Of particular note, the Taskforce recommends creating an Enterprise Capital Fund for labour intensive businesses, highlighting the job creation objective of support for small business.

New local solutions
The Taskforce recommends a range of solutions to the problems created by banking over-centralisation. It has developed a model for what it calls 'Sparks', based on the Sparkassen principles.

- An individual bank must operate only within its designated geography.
- All loan decisions must be made by people located at that particular bank in that geography.
- The people making those decisions live in that geography giving them contextual knowledge.

Each Spark would be a separate autonomous trust answerable to local stakeholders including, for example, local government, local enterprise partnerships (LEPs), and local chambers of commerce. Each would be initially capitalised with £10m of public equity and £90m of private debt. Sparks small enough to be effective lenders are unlikely to be large enough to access capital markets on their own, but the network of Sparks acting together would be. So a central 'Spark Umbrella' would raise capital by selling long-term bonds to private investors. The Spark Umbrella would also, for a fee, provide back-office support to individual Sparks. Sparks could relate to the BIB as the Sparkassen relate to the KfW, which does not have its own distribution network.

1.3 What this report adds to the discussion

While much of the work quoted is impressive, it does not resolve two quite fundamental and interlinked issues. The first is the mandate of the bank, that is, the problem the bank is designed to solve. The second is how to distribute the bank's products so that all parts of the country benefit – especially the regions that need the bank most.

For the most part, the proposals described above define the main problem as information failure in the SME lending and investment market, that leads to short-termism and high transaction costs (as set out in Section 1.2). So, they typically propose a mandate – either explicitly or implicitly – that would facilitate as much SME lending (and in some cases equity investment) as possible within the constraints of viability and capital ratios.

Skidelsky *et al* and the Small Business Task Force appear to recognise the existence of externalities or broader economic returns to investment which might drive decision making, but this has not been the main thrust of work to date.

In Chapter 2, we argue that – like many publicly owned banks around the world – the BBB should have a broader economic mandate. In Chapters 3 and 4, we describe how this could be put into operation through a performance measurement framework and a set of products and processes for management. In Chapter 6, we look at how the bank might work with other agencies.

Tackling the information problem requires loan officers and investment managers who thoroughly understand the businesses and localities they are investing in. An investment bank might be able to incentivise existing commercial banks to create this skill base and then distribute its products. (This has been proposed by the Government and in one version of the IPPR's proposals). However, it is not guaranteed that this will work. We look at the alternatives to this in Chapter 5.

It might be possible to find new ways of co-investing with private sector funds to support investment in innovation. But again, this is not guaranteed to work – especially as evidence suggests the shortfall in equity investment is partly a problem of demand as well as supply,[10] i.e. there is a shortage of businesses ready for investment. So alternatives must be sought.

2. The bank's mandate: good, sustainable jobs in all parts of the country

In this chapter we argue that the bank's mandate should do more than maximise lending to SMEs. It should support an industrial strategy that delivers good, sustainable jobs. This should be combined with a profit target somewhere between the government's cost of capital and commercial banks' targets, so that the bank can gradually grow its reserves. (We return to performance measurement and targets in Chapter 3).

An industrial strategy is needed because there are too few good jobs in the UK economy, for both graduates and non-graduates. In addition, the transition to a sustainable economy – one that can survive and thrive in a world where externalities are priced and regulated – is too slow.

The ultimate objective of the strategy – as of all public policy – will be good lives now and in the future. This is uncontroversial. The intermediate objective should be to maximise good, sustainable jobs, as opposed to gross domestic product (GDP). The evidence is clear that a broader intermediate objective than GDP growth is needed.

The bank should be part of delivering this strategy because it can:

- incentivise business to align with the strategy
- send a strong message about the government's commitment to the strategy
- help co-ordinate finance and other forms of business support
- internalise externalities
- and feedback from the front line into the strategic process.

There are potential difficulties – such as lending to lame ducks, failing to incentivise the rest of the banking industry, and putting off viable businesses with bureaucratic processes or criteria that are too strict – but these can be dealt with.

Overseas, many publicly owned banks have broader mandates than lending as much as possible to SMEs (see Table 1). Of course, this in itself is not an argument, but it does show such mandates are feasible and that they can be combined with SME lending.

2.1 The UK needs an industrial strategy

All governments intervene in the economy to improve its performance. They subsidise infrastructure, education and research, encourage entrepreneurship and attempt to reduce co-ordination failures.

However, by 'industrial strategy' we mean the active co-ordination of such interventions to influence the mix of activities in the economy and ultimately improve the quality of jobs. For example, public procurement, investment in skills and new financing products could all be deployed to support a new sector. This is what corporations do anyway, but with an industrial strategy, government would be doing it on behalf of the workforce (i.e. citizens) rather than shareholders.

Table 1: Mandates of banks overseas

Institution	*Mandate or mission statement*
KfW	To sustainably improve the economic, social and ecological condition of people's lives
US Small Business Administration	To aid, counsel, assist and protect the interests of small business concerns; to preserve free competitive enterprise and to maintain and strengthen the overall economy of our nation.
BNDES	To contribute to the economic development of Brazil, including sustainable socio-economic development, technological innovation and the modernisation of public administration.
Council of Europe Development Bank	Strengthening social cohesion in Europe; strengthening social integration; managing the environment; supporting public infrastructure with a social vocation.
Nordic Investment Bank	To promote sustainable growth by providing complementary financing based on sound banking principles which strengthen competitiveness and enhance the environment.
European Investment Bank	To support projects which make a significant contribution to growth, employment, economics, social cohesion and environmental sustainability in Europe and beyond.

This attempt to shape the economy is attractive because, left to itself the market has been producing sub-optimal outcomes for some time and is predicted to continue doing so.

Between 2003 and 2008, UK GDP grew by 1.4 per cent a year, but gross disposable income per head fell by 1.1 per cent. Male median hourly earnings rose by 0.1 per cent a year, while female median hourly earnings rose by 0.7 per cent a year.[11] These figures hide significant regional variations: gross disposable income per head fell by 4.1 per cent in the eastern region and rose by 3.9 per cent in London.[12]

This stagnation and regional variation is reflected in the growing number of non-graduates – and less successful graduates – working in low-paid, insecure, dead-end jobs.[13] In an earlier paper, we characterised the problem as a shortage of good jobs for non-graduates but it increasingly affects graduates too.[14] Despite rhetoric about the 'knowledge economy', the demand for 'knowledge workers' is not as great as governments often claim. So, many graduates who expect interesting, well paid jobs are unlikely to find them.[15]

Without action the situation is likely to get worse. Sectors that offer a high proportion of decently paid jobs are forecast to decline. Most employment growth is projected to be in sectors that pay badly. In other words in the absence of policy action, it is likely that the labour market will hollow out even further.[16,17]

It is clearly better that people should have safe, secure jobs paying £30,000 a year than dangerous, insecure jobs paying £15,000 a year. Some activities result in better jobs than others, so if an industrial strategy can stimulate these activities, then clearly it is desirable. The issue is whether such a strategy would work, or whether negative unintended consequences would outweigh the benefits.

Although economic theory and policy from the late 1970s onwards restricted government intervention – and attempts to favour certain sectors over others was associated with 'picking winners' and supporting inefficiency – a more active approach has come back into favour. Ha-Joon Chang writing in the tradition of Friedrich List, and Dani Rodrik from a more mainstream, neoclassical view, are among the theorists rekindling interest. In the UK now, an active approach has political support from all sides.

Industrial strategy has played an effective role in East Asia, although some argue that mature economies respond less well to sector-based intervention – largely because they are at the technological frontier rather than in catch-up mode. But the examples in the box suggest that such intervention can be effective in Europe, and illustrate the kind of concerted approach needed.

BOX 4: Industrial strategy examples

Below we describe three comparatively recent applications of sector-based industrial strategy in Europe to show how, in different circumstances, governments have successfully shaped economic outcomes. The cases illustrate the tools used and clarity of purpose. The Finnish example in particular draws attention to the importance of the public-private institutional arrangements and leadership needed to make things happen.

Finland

Finland suffered one the worst recessions in its history in the early 1990s. At the time its major trading partner was the USSR, whose collapse and disintegration had an enormous impact. Meanwhile, financial market deregulation led to rapid interest rate increases and Finland plunged into a slump. Unemployment reached 20% by the end of 1990. Finland's economy was largely focused on primary goods and heavy industry. The cost pressures of globalisation, driven by rising competition from elsewhere in the world, left it struggling.[18]

The government response to this was ambitious, overhauling Finnish economic policy and setting out a vision for the country as a 'knowledge economy'. It built on Finland's strengths in engineering, and focused on the emergence of a cluster of telecommunications companies around the University of Helsinki. Technological innovation in emerging industries – supported by government action in wider society – transformed the Finnish economy. A new economic strategy, published in 1993, outlined the transformation the government wished to see.[19]

Finland had some existing institutional capacity to deliver this strategy. The Science and Technology Policy Council (STPC) – established in the 1960s as a cross-party body chaired by the prime minister – oversaw science and technology policy. Its political profile and high-level membership – of ministers, business leaders, trade unionists and scientists – gave it the authority to establish a shared vision of the economic transformation and, crucially, the leadership needed to deliver the strategy. In line with Finland's tradition of welfare and egalitarianism, promotion of business and technological innovation was combined with social measures, primarily education and training. This helped ease the transition from older industries to the 'knowledge economy'.

Productivity growth rose by almost 30% over the rest of the decade. From being a manufacturer of leather products, Nokia became a leading mobile phone company. Finland became one of the world's largest exporters (by share of total exports) of high-technology products. It remained, alongside that, a far more socially inclusive and equal society than other high-tech hotspots, like Silicon Valley.[20]

Britain

Industrial policy and sector-specific government intervention fell out of favour in the UK in 1979 – at least until the crash of 2008. Successive governments have emphasised reliance on market-led mechanisms to drive investment and economic transformation. 'Competition policy', stressing the need to create a level playing field for competing firms, replaced active industrial policy.

The financial crisis and subsequent recession shifted the rhetoric, with first Labour ministers and then the Coalition government beginning to recognise the need for a policy shift. Former Conservative minister, Michael Heseltine's report, *No Stone Unturned in the Pursuit of Growth* (2012), presented a forceful, business-friendly case for more active industrial and regional policy. But industrial policy in the UK was never completely discarded: for one sector of strategic, national importance, it has been quietly maintained.

Aerospace in the UK appears to be a resounding industrial success story. In 2006, the industry employed some 124,000 people and turned over £19.81bn. It exports over 60% of its output, contributing £1.54bn in surplus to the balance of trade. By some measures, the UK industry is the world's second largest. Airbus, a joint European venture, is one of only two major civil aircraft manufacturers globally. Airbus UK has plants at Filton near Bristol, and Broughton, north Wales.[21] Employment has declined, from approximately 250,000 in 1980, but productivity has increased – from £55,000 value-added per worker in the same year, to £159,500 in 2006.[22] Rolls-Royce, meanwhile, is the world's second largest manufacturer of aero engines, with major plants at Derby, Bristol and in Lancashire, and a headquarters in London.

But the industry has long been subject to government intervention. Rolls-Royce was nationalised by the Conservative government in 1971, after suffering financial difficulties. British Aerospace was formed in 1977 from the nationalisation and merger of British Aircraft Corporation, Hawker Siddley Aviation, Hawker Siddley Dynamics and Scottish Aviation. The first two of these were also the product of a previous, government-led consolidation in 1960, following the recommendations of the 1957 White Paper on Defence.[23] British Aerospace was privatised in 1981, and became BAe Systems in 1999 following its merger with defence electronics specialise Marconi Electronic Systems. Rolls-Royce was privatised in 1987.

Despite eventual privatisation, both Rolls-Royce and BAe Systems have been directly influenced by government because of their reliance on defence contracts – particularly so in the case of BAe Systems following its 2006 disposal of its Airbus shares. Close relationships were developed with the major government buying department, the Ministry of Defence, even as arms production itself became increasingly globalised. By 2005, the government explicitly identified "which industrial capabilities we require to be sustained onshore" in the interests of preserving "sovereignty" in that year's Defence Industrial Strategy (DIS).[24]

It has been suggested that BAe Systems functions as a "national champion" – a single, leading firm that receives significant government attention and support.[25] BAe's CEO, at the time of the DIS publication, indicated its importance to the company, saying, "If we didn't have the DIS… then there had to be a question mark about our future stay in the UK". [26] The DIS assumed that meeting future military needs (and likely needs) would require a well supported market for military products and services, with several suppliers efficiently meeting the complex material demands of modern warfare.[27] Following a change of government, the document has since been superseded by 2012's *National Security Through Technology*, which weakened some of the commitments previously made to specific technologies. However, the approach has remained the same, involving close co-operation between government and long-established suppliers.

Denmark

Today, Denmark is the world's leading exporter of wind turbines, holding around 50% of the global market. It generates around 20% of its own energy from wind. This stems from a government policy in the 1970s to promote the use of renewable energy. Developed as a response to rising oil prices, and to make use of Denmark's geographical advantages, the first Danish renewable energy strategy was published in 1976. Initially it sought to reduce Denmark's dependency on imported energy and therefore its exposure to price spikes. Environmental issues became a concern more recently.

The initial strategy fell into four parts:[28]

- a comprehensive research and development (R&D) programme, committing resources to renewables research. About 10% of Denmark's research budget since 1976 has been spent on wind energy
- turbine certification allowing turbines to connect to the Danish grid, maintain quality of production and enable the Riose Test Station to function as a repository of practical knowledge
- an initial capital subsidy of 30% of the costs of installing a turbine, which helped encourage 200-300 turbine installations a year from 1976 to 1989, when the subsidy was removed as a result of falling turbine costs
- mandatory pricing for Danish electricity suppliers, who were required to pay 85% of the retail price of electricity to private generators of wind power.

Importantly, Denmark encouraged the establishment of 'wind guilds'. The guilds are local co-operatives whose members buy shares in new installations of turbines. In return for an initial, usually small, equity investment, members receive a share of profits generated by their wind farm. This has helped overcome what can be substantial local opposition to new wind schemes. Over 100,000 Danish families own either wind turbines or shares in wind guilds.

By promoting domestic demand, protecting the nascent industry through state support, and developing mechanisms to allow the rapid, bottom-up spread of wind technology, Denmark has been establish a lead in the provision of wind turbine technology.

2.2 The objective of this strategy should be to maximise good, sustainable jobs

Industrial strategy usually sets out to grow the economy over the long term, with the implicit assumption that this will improve life quality for citizens. We recommend that industrial strategy should prioritise life quality by targeting a new intermediate objective: the provision of good, sustainable jobs all over the country for those who want them.

The traditional argument states that GDP growth is the best intermediate objective, because it raises living standards – so if markets work efficiently, GDP is a reasonable proxy measure for welfare. It also increases the tax base, which matters to everyone, particularly the less well off, who depend on transfers and benefits in kind. What's more – so the argument goes – increased GDP raises the potential for investment in new technologies and assets that will deal with environmental threats and on which our future well-being depends.

Unfortunately the evidence contradicts this theory. First, rises in GDP have not translated into rising living standards in recent years – except at the top of the income distribution. Second, constraints on transfers limit the contribution of the tax base to well-being. Third, although living standards contribute to a good life, they are not the only thing that matters. And fourth, rising GDP may create potential for investment in the future, but this potential is not being realised. These arguments are set out in greater detail in Box 5.

BOX 5: Is GDP growth a good objective for industrial strategy?

We set out here the argument summarised in the main text that GDP growth on its own is not an adequate target for long-term economic policy.

Rises in GDP have not translated into rising living standards for the bulk of the population.
As argued on page 11, the growth in UK GDP of 1.4% a year between 2003-08 UK did not raise living standards. This is reflected in the growing number of non-graduates – and less successful graduates – working in low-paid, insecure jobs. Without action, the situation is likely to get worse.

Living standards have risen among those with the highest incomes. But – leaving aside questions of social justice – this is the group for whom income matters least. Household income is critical for the well-being of those on low incomes – material deprivation is unsurprisingly a major cause of low well-being, as is inadequate housing[29]. However, the relationship weakens as income rises, in line with the falling 'marginal utility of income'.[30] One US study suggests the relationship disappears altogether above $75,000 if you define well-being in terms of feelings.[31]

Constraints on transfers limit the contribution of the tax base to well-being.
It used to be argued that these inequalities do not matter because tax, benefits, and benefits in kind can sort things out. Historically government transfers have made a huge difference. But in a period of austerity (i.e. low or negative growth rates), it is hard to get the level of tax and benefits needed to fund top class public services and tackle inequality.

While growing the tax base is important for funding public services, it is no longer an alternative to equitable initial distribution. In any case, it is not clear that the tax payer should subsidise low-paid industries or make a large proportion of the population dependent on state benefits. The phrase 'pre-distribution' has been coined in recognition of the need to achieve a fairer distribution before transfers – whether through industrial strategy or collective bargaining.

The economy doesn't just influence well-being through living standards
The evidence from statistical analysis of well-being survey data shows that the economy influences well-being in different ways. Income is not the only factor and once deprivation is dealt with, other factors become increasingly important and are not necessarily driven by GDP.[32] We discuss some of these later in this chapter.

Potential investment for the future is not being converted into the levels of actual investment that we need
The transition to a sustainable economy cannot be achieved through carbon pricing and other forms of tax or regulation alone. This would create adjustment costs (higher prices, unemployment, disruption) that cannot be tolerated in democratic states. We have to invest in both creating jobs to bring the transition about (in renewable energy for example) and in jobs that will survive the transition (that is, jobs in all kinds of sectors).

So far this is not happening on the scale needed. Using International Energy Agency figures, the United Nations Environment Programme (UNEP) estimates that halving energy-related CO_2 emissions by 2050 will require additional investment of 1% to 2.5% of GDP every year between now and then.[33]

In theory, the necessary investment could be made as a result of market signals – for example, statements by the government about carbon prices in the 2020s. In practice, such statements are not credible. Direct interventions are needed and the government must put its money where its mouth is. As UNEP argues, governments need to use their own resources to leverage the necessary private sector finance.

We still need growth in the short to medium term. We need a macro-economic policy that delivers sufficient demand at home, and an exchange rate that encourages demand from overseas. Growth may also be necessary for maintaining employment in an internationally competitive environment. But good lives depend on the quality of economic activity as well as the quantity. That's why there is a growing international and mainstream consensus that growth is not enough as a foundation of economic policy.[34] This view is shared by the public: research by PwC and Demos suggests the public do not simply want growth, they want 'good growth'.[35]

So while short-term, macro-policy might target GDP growth, longer-term industrial strategy needs an objective that captures the quality of this growth. This is why we recommend an intermediate objective of providing good, sustainable jobs all over the country for those who want them. By 'good jobs' we mean those that provide:

- a decent income
- job security
- opportunities for progression
- satisfying work
- an employee voice
- decent conditions
- and work life balance.

We present the evidence for this definition in Section 2.3 below.

For many, a good job is fundamental to a good life. Good jobs for everyone who wants them would create a fairer society. And because they pay well, good jobs also create a larger tax base, helping to fund public services.

By 'good, sustainable jobs' we mean good jobs that:

a) will last and be commercially viable after the transition to a low-carbon, sustainable economy and

b) do not threaten environmental sustainability and so reduce the prospects for other good jobs in the medium to long term.

There may be a trade-off between maximising the number of jobs, and maximising the number of those that are good and sustainable. The right balance will depend on an assessment of costs and benefits over the long term. We return to this in Chapter 3.

2.3 Evidence supporting our definition of a good job

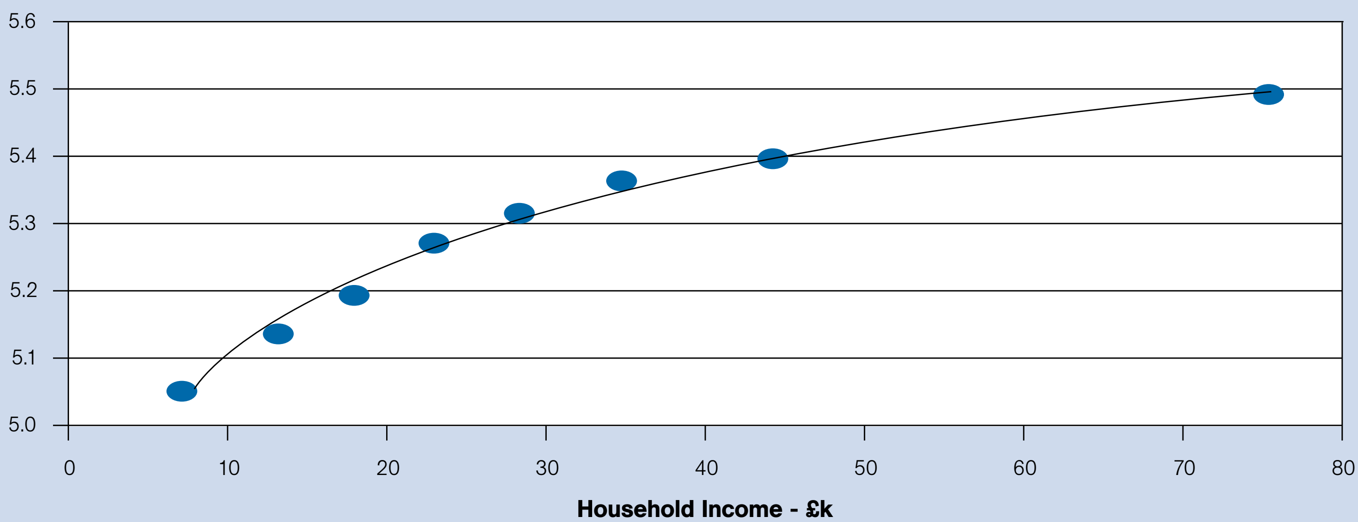
Our definition of a good job is supported by the evidence on the drivers of well-being. We take it as self-evident that maximising well-being now, and in the future, is the central goal of public policy as a whole.

A decent income matters, particularly for those on low incomes

Numerous studies have investigated the relationship between income and well-being.[36] They show that income matters, but the increase in well-being associated with an additional £1,000 is considerably higher for those on low incomes than those on high income. (See the chart above).

A famous US-based study – by Nobel Prize winner, Daniel Kahneman and Princeton economist, Angus Deaton – found that higher levels of income were associated with higher levels of happiness and lower levels of stress, but only on incomes up to $75,000.

Figure 2: Relationship between life satisfaction and household income



Job security matters

nef analysis into UK well-being data revealed that workers on temporary contracts experience much lower levels of life satisfaction: and higher levels of anxiety, and feel that their life is less worthwhile, than those on permanent contracts.[37] The differences in well-being are large – about a third of the size of the difference between the employed and the unemployed. A **nef** analysis of similar European data suggests the difference is as much as one half of that between the employed and the unemployed. Other studies have found that casual workers experience lower levels of well-being than full time workers.[38]

Data from the International Social Surveys Programme suggests that most employees consider job security desirable.[39] A study by PwC and Demos found job security was the most important job-related personal economic factor.[40]

Opportunities for progression matter

Several studies have found positive correlations between job satisfaction and opportunities to develop new skills.[41] Others have found similar relationships for goal setting,[42] and positive perceptions of an employer's attitude towards staff development. On the other hand, under-utilisation of skills is often associated with low job satisfaction.[43]

Satisfying work matters

Including job satisfaction in the definition of a good job is justified because, first, many studies have found job satisfaction contributes to individual well-being.[44] Secondly, many empirical studies of well-being at work use job satisfaction to examine the relative importance of job characteristics.

Pay is often correlated with many elements of a good job, but it is not a perfect proxy. Evidence suggests other factors (for example, trust in management) have a stronger relationship with job satisfaction than personal income.[45] A sense of control over your working life is also important.

Employee voice matters

Evidence suggests there is less absenteeism and staff turnover in businesses where employees can express views and those views are taken seriously. The TUC cite a 2007 government report measuring subsequent savings to employers of £72-£143 million.[46] The same report shows that employee voice makes employees feel they have more control over their working lives, leading to greater job satisfaction (and substantial productivity benefits).

Decent conditions matter

Several studies have found a correlation between improvements in physical working conditions and improvements in well-being. Bad physical conditions are associated with low well-being.[47] Robertson and Cooper (2011) consider job conditions to be one of the key workplace factors in their model of employee well-being.[48]

Work-life balance matters

Individuals vary as to how many hours they wish to work. However, evidence suggests too many, or too few, hours can damage well-being. **nef** analysis of UK well-being data suggests those working part time with too few hours had much lower levels of well-being than those in full-time work. The difference in life satisfaction was about half what it was between the unemployed and the employed.[50]

Working excessive hours can also be damaging. Harter and Arora (2010) note long hours negatively impact on stress, disease burden and occupational injury.[51] ONS well-being data suggest that those working 55 hours a week or more experience higher levels of anxiety and lower levels of happiness than those working under 55 hours.[52]

A study by the European Foundation for the Improvement of Living and Working Conditions found that most (51 per cent) of the European Union's working population would like to reduce their hours and would "accept a corresponding drop in income to achieve this". At the time of the study, only 12 per cent of employees wanted to work longer hours.[53]

Employment matters

There will sometimes be a trade-off between maximising good jobs and maximising the number of jobs. Evidence shows that being unemployed is highly damaging to well-being. The unemployed experience lower levels of life satisfaction, lower levels of happiness, worse psychological well-being and higher levels of anxiety than their employed counterparts. Several studies have found the loss of well-being associated with unemployment exceeds the reduction in well-being attributed to loss of income. Blanchflower and Oswald (2004) estimate the well-being cost of unemployment in the US is $60,000 higher than the associated loss of wages.[54,55]

BOX 6: Definitions of good jobs and good work proposed by other organisations

Over the years, several organisations have proposed definitions of good work or a good job. In this box, we put forward a selection of these conceptual definitions.

According to research by the Work Foundation, the first concerted effort to develop good work as a general policy concept was by the Swedish Metal Workers Foundation in the 1980s.[56] They proposed a concept of good work with nine elements:

1. job security
2. equal and fair share of production results
3. worker co-determination
4. collaborative work organisation
5. skills and competence development at all levels
6. recurrent education/lifelong learning
7. flexible and employee-friendly working hours
8. workplace equality and social inclusion
9. a healthy and risk-reducing work environment.

In 1999, the International Labour Organisation attempted to define and advance the concept of good work.[57]

> *"Decent work means productive work in which rights are protected, which generates an adequate income, with adequate social protection. It also means sufficient work, in the sense that all should have full access to income earning opportunities. It marks the high road to economic and social development, a road in which employment, income and social protection can be achieved without compromising workers' rights and social standards."*

In 2000, the EU's Lisbon strategy suggested Europe's approach to employment should focus not just on creating more jobs, but on creating better jobs.

> *"Increased effort should be made to promote a good working environment for all including opportunities for the disabled, gender equality, good and flexible work organisation permitting better reconciliation of working and personal life, lifelong learning, health and safety at work, employee involvement and diversity in working like."*

European Council (2000)[58]

The European Foundation for the Improvement of Living and Work Conditions (Eurofound, 2012) built on this, and developed a concept of good jobs with four elements:[59]

- ensuring career and employment security
- developing skills and competencies
- maintaining and promoting the health and well-being of workers
- reconciling work and non-work life.

In response to the record high levels of employment reached in the mid 2000s, the trade union, Amicus (now part of Unite) turned its attention to good work and better jobs. Amicus identified five key elements associated with the quality of people's working lives:

- a safe and healthy workplace
- control over the working environment – including working hours
- secure and interesting work
- fairness and dignity at work – including fair pay
- a trade union voice

2.4 The BBB can be an important tool for delivering industrial strategy and good jobs

If the Government has an industrial strategy – and strategy means the active co-ordination of government interventions in the economy – then it makes sense for the BBB's activities to be co-ordinated with other interventions and for its mandate to reflect the objective of the strategy.

The objective we have proposed is demanding, and unlikely to be achieved unless there is concerted co-ordination of the different levers available to government: procurement, skills system, knowledge transfer, infrastructure, labour market and trade union policy, grants, export promotion, inward investment support – and the BBB.

A mandate and performance measurement framework shared by different public agencies– or a set of frameworks that fit effectively together – will help this co-ordination. It will encourage the kind of collaboration at regional level that has underpinned successful economic development overseas, and which cannot be pre-specified by those drawing up the terms of reference of the various agencies involved.[60]

In addition to this general point, the BBB is an important tool for delivering the strategy for five reasons, outlined below.

1. It can incentivise business to align with the strategy and deliver good jobs

Businesses want access to finance on decent terms. Because the BBB will provide this in a way other banks will not, SMEs will have an incentive to meet its criteria – including offering good, sustainable jobs in the short term, and aligning with industrial strategy over the longer term. The BBB's activities will also result in a form of natural selection, because businesses that meet its criteria are more likely to find the finance they need, so more likely to survive and grow.

2. It can send a strong message about the government's commitment to the strategy

Industrial strategy involves a form of indicative planning, where predictions become self-fulfilling prophecies as businesses respond to them. The power of this approach has long been recognised in monetary policy, with the role of inflationary expectations being a key reason for favouring operational independence for central banks. An example of indicative planning is the 'forward guidance' issued by the new governor of the Bank of England, which sets out criteria that could to lead to future changes in interest rates.[61]

But government often faces a credibility problem (for example over the future of climate change policy) when business asks it to put its money where its mouth is. The BBB – owned by the government and *de facto* guaranteed by the government – will involve the government doing just that.

3. It can help co-ordinate finance and other forms of business support

Evidence shows much of the SME finance problem is on the demand side: a shortage of well managed, investment-ready companies (see page 38). As the BBB has an interest in the success of its investee companies, it makes sense for it to help these companies become investment ready. So the BBB potentially has not one but two 'levers': cash and help. If the industrial strategy's objective is good jobs, the BBB should prioritise this support on companies who are likely to provide these jobs.

4. It is an efficient way of internalising externalities

If you believe the mandate should be maximising lending to SMEs, you may believe what is needed is more investment in information than the market is currently prepared to deliver. Once this information is available, decisions can be made on traditional financial grounds.

In reality, widely recognised problems such as short-termism, and the absence of patient capital to finance radical innovation, may not stem from information failure, but failure to consider positive externalities, such as: knowledge spillovers; impacts on the market for skills; critical mass effects; impacts on the supply chain and clusters, and so on.

In such cases, even given all the knowledge it is possible to have, short-term investments may offer better risk return profiles for the investor – but not society. Private venture capitalists may overlook innovative, game-changing technologies, even if they would be financially viable with a low cost of capital and offer potentially high returns for the economy as a whole. This is because of the relatively low expected private return or the high degree of uncertainty as opposed to quantifiable risk.

Other externalities may be in the labour market: for example the creation of jobs suitable for the long-term unemployed, or the creation of jobs which result in skill development, in turn leading to more good jobs in the region.

From society's point of view, there is a danger that a narrow mandate for the BBB will result in it ignoring these returns and that it will reinforce, rather than disrupt the low-wage, low-skill, low-innovation equilibrium that characterises too many SMEs in the UK – particularly those serving domestic markets.[62] So these returns must be taken into account and assessed. This will not happen by using the purely financial assessment implicit in the SME mandate/information failure problem model. Assessment can either replicate market criteria (albeit with better information) which do not take into account externalities, or use a lower than market hurdle rate. In the latter case there is an implicit subsidy, which should not be provided in the absence of some assessment of the broader return – that is, whether the taxpayer is getting value for money.

It may be counter-argued that banking decisions should be taken on a purely financial basis, and that externalities should be addressed through explicit subsidies, managed separately from the BBB. The BBB would then be designed to solve the problem of information failures in the market for SME finance and nothing else. This, so the argument goes, would allow bankers to make the decisions they make well, leaving politicians and officials to make the decisions they make well. Any deviation from this principle simply muddies the water.

This is theoretically neat but entirely impractical. It could only work if all investment propositions could be submitted simultaneously to a banker and an official. They would calculate the financial and broader economic net present values respectively, add them together, and if the result was greater than zero, draw on their respective funds to invest in/subsidise the business. This would never happen.

If externalities are to be taken into account (and lower than market hurdle rates used) it is important that criteria for assessing them are explicit. There's a danger the BBB might become a tool for supporting unviable businesses, or advancing private or political interests. So we recommend an explicit good jobs mandate and performance measurement framework. (NB Investments in projects and businesses of any size may feature positive externalities. There is no reason to suppose they are confined to SMEs.)

5. It can feedback from the front line into the strategic process

The strategy is not simply a top down plan, but a steadily evolving process requiring intelligent responses to developments in the business world. The BBB could offer this because it will need loan officers and investment managers who understand the businesses and localities they are investing in. (If this function is sub-contracted to partner banks – see Section 4.1 – individuals who understand enough to manage these contracts will also be able to get detailed feedback.) The BBB will need people on the ground in all parts of the country and specialised sector and technological knowledge. Its people will be well qualified (perhaps better qualified than officials and politicians) to make the impartial business-by-business assessments needed for an effective industrial strategy.

These five arguments (with the general argument in favour of co-ordination) underpin our recommendation for the BBB's mandate: 'to ensure that a sufficient number of good, sustainable jobs, for everyone who wants them in every part of the country, is not constrained by a lack of appropriately priced finance, while achieving a target level of profit'. The mandate should be linked to a performance measurement framework. Both should be written into the BBB's memorandum of association and any relevant legislation.

2.5 Counterarguments against a good jobs mandate do not stack up

We have heard four counter-arguments that identify potential difficulties with a good jobs mandate, which could outweigh the benefits just described. None of these arguments stack up. The difficulties either do not exist or can be dealt with.

A good jobs mandate will encourage lending to 'lame ducks' – businesses that are not viable and cannot get funding anywhere else

The BBB will have an obligation to make a profit and a set of hurdle rates for assessing returns. The target profit rate will be lower than that of commercial banks, but that does not mean it will invest in non-viable businesses.

An explicit good jobs mandate and performance measurement framework gives the BBB an incentive to invest in businesses that contribute to the long-term success of the regional and national economies. Businesses cannot do this unless they are viable. Without this mandate, any state owned bank with lower hurdle rates than commercial banks is *more* likely to invest in marginal businesses than it is with the mandate.

A good jobs mandate will stop the bank encouraging the rest of the banking sector to lend to SMEs ('crowding in')

This argument says the BBB should set an example and encourage other banks to lend to SMEs, but if it pursues non-financial objectives and then achieves a lower than market return, its example will not be followed.

This is to misunderstand the way the BBB can encourage other banks to lend to SMEs. It will do so, not by example, but by using other banks as its distribution channel: providing funds on terms which encourage them to invest in the skills and systems needed to lend to SMEs. Once these skills and systems are in place, other banks will be able to access funds from other sources to lend to SMEs.

For a local banking sector – with banks mandated to lend within a particular geographic area – this lending would be the main opportunity, and would create a huge incentive to develop the skills and systems needed to lend effectively to SMEs. In Germany, the KfW is vital to making the Sparkassen work, but it is not their only source of funds. They lend using other funds and the KfW's broader economic and social mandate does not worry them at all.

A good jobs mandate will discourage viable growth businesses from applying for finance

There are two points here. One is that the process itself could deter applicants. We accept that this is a danger, and agree that it is vital that processes do not become a burden on applicants. We return to this in Chapter 4.

The other is that good businesses will not get the finance they need, either because they are rejected or the good jobs criteria puts them off applying. Presumably if the BBB allocates all its funds and has to ration them, no-one would object to it financing good, rather than bad, jobs. But what if too few businesses pass the tests? And funds are not all allocated, or worse, lent to unviable businesses?

In Chapter 3 we argue that national and regional boards should be flexible when setting targets for management, although they should use a fixed performance measurement framework. This would allow a regional board to adjust the targets if too few high-quality SMEs were applying. Flexibility would minimise the possibility of the BBB failing to allocate its funds, as there will be periods when any jobs will be worth having and the quality of the jobs will be less important.

BOX 7: Broader economic or social mandates overseas

National investment banks – and other publicly owned banks – typically have a specific economic or social mandate. They are often founded to help tackle social problems, such as financial exclusion,[63] and invest profits in the community.[64] National investment banks also have a critical role to play in correcting market failures.

Public banks appear to be better than commercial banks at long-term lending to domestic enterprises. For example, in 2012 commercial and public banks in Germany were responsible for 46% and 33% respectively of short-term lending to domestic enterprises. With long-term lending to domestic enterprises, the tables were turned: commercial banks and public banks were responsible for 20% and 45% respectively.

Similarly, the Japanese Finance Corporation (JFC) reports:

"Given that it generally takes about 50 years for a forest to develop and so recovering any capital takes a very long time, many forestry operators face difficulties in securing loans from private financial institutions…For this reason, the Agriculture, Forestry, Fisheries and Food Business Unit supports forestry operators by providing the ultra-long-term, low-interest finance that is required until logging. (Average loan period = 25.5 years)."[65]

Agricultural businesses may also struggle to secure commercial financing, for example, because annual incomes can be adversely affected by weather. National investment banks often offer flexible repayment terms, to help businesses in unexpected times.

National and international investment banks tend to focus on long-term lending for SMEs and infrastructure projects. Many national investment banks only provide long-term loans. The Brazilian Development Bank (BNDES) describes itself as the main source of long-term financing in Brazilian Real, and essentially the only source of long-term financing for SMEs.

These banks don't just target market failures in the long-term lending market. BNDES has an equity arm that provides seed money, venture capital and private equity funds. This subsidiary exists specifically to promote the Brazilian capital markets, which, by international standards, are still only in their infancy.

National investment banks have played an important counter-cyclical role by stepping up lending during financial crises. The Business Development Bank of Canada (BDC) increased its balance sheet by 46% between 2009 and 2010.[66] The JFC SME unit stepped up lending by 115% between 2007 and 2011.[67]

As well as playing a counter-cyclical role during financial crises, national investment banks can help at other times of national emergency. The JFC introduced an additional ¥5,394bn programme specifically in response to the Tōhoku earthquake and tsunami, and subsequent Fukushima Daiichi nuclear disaster. This programme now represents 25% of the institution's loan portfolio.

A good jobs mandate will be impossibly bureaucratic to implement.
There are two responses to this point. First, there are successful state owned banks around the world with broad economic and social mandates. They are bureaucratic – as banks should be – but not impossibly so. There are also numerous public programmes in the UK that use performance indicators other than profits. These also are bureaucratic, some impossibly so, but not all. There is plenty of experience to draw on that shows how to keep bureaucracy at necessary, rather than excessive, levels. In particular, once the principle of a good jobs mandate is accepted, detailed work on streamlined assessment processes will be needed. (See Section 4.3 for more on this).

The second response is that we recommend a clear mandate and a strong performance measurement system. Of course effective financial controls are needed, but by being clear about what must be achieved, more discretion can be given as to how to achieve it. This should reduce unnecessary bureaucracy.

3. Putting a good jobs mandate into operation: 1) performance indicators

In Chapter 2 we recommended a mandate for the BBB: to ensure that enough good, sustainable jobs for those who want them in all parts of the country, in the short and long term is not held back by lack of finance. In this chapter we describe how the government and the BBB's national and regional boards could use indicators, targets and rules to ensure management advances this mandate.

Indicators and targets have been controversial in some parts of the public sector, usually where they cut across a well established professional ethic (as in education and health care). But they will be essential for the BBB. Without a mandate to maximise profits – or a well established professional ethic to maximise good, sustainable jobs – targets are needed to prevent managers simply maximising volume, or worse, being influenced or corrupted by their own or more powerful interests. (See Chapter 6 for examples of this.) Of course, the design of the targets will require further work to prevent gaming.

Indicators should, like the mandate, be for the short and long term: short-term indicators to measure the number of good, sustainable jobs the BBB has helped create; long-term to measure how the BBB is supporting an industrial strategy for good jobs, and whether it is helping the economy move in the right direction.

Note that neither of these indicators report directly on what the BBB has done: they are outcome indicators, not output indicators. They may be as influenced by the actions of other agencies (or uncontrollable events) as by the BBB itself. This is deliberate. The BBB's management may develop output indicators to monitor its performance, but the performance measurement framework described in this chapter should be outcome based.

The indicators are not targets themselves, but can be used as the basis for targets. We discuss target setting – including profit targets – in Section 3.3.

3.1 Short-term indicators

The choice of indicators is a balance between what one would ideally measure (given the definition of a good, sustainable job in Chapter 2) and the data that is or could be available.

The BBB's short-term performance indicators (PIs) should be based on national and regional 'good, sustainable jobs' indicators. These measure national or regional performance so are not PIs for the bank. They can be grouped into four themes: unemployment, pay/income, job quality other than pay, and $C0_2$ emissions. See Table 2.

Most of these indicators already exist and are published. Regional data for each of these or similar indicators are provided in Table 4. (To implement our proposals, Office for National Statistics surveys would need some modification.)

These national and regional indicators will not tell the board, or the public, whether management is doing a good or bad job. The outcomes are subject to too many other influences. The experience of the regional development agencies (RDAs) showed it is impossible to disentangle the impact of different interventions. The indicators do three other important jobs.

Table 2: National and regional short term indicators

Category		Core indicators	Supplementary indicators
Unemployment		• Unemployment rate	• Youth unemployment rate • Long-term unemployment rate
Pay/income		• Median Wages	• Median household income • Proportion of working-aged individuals in low income households
Job quality (other than pay)	Working hours	• % working more than 45 hours a week • % under-employed	• Average working hours
	Job security	• % who feel it is likely or very likely that they will lose their jobs in the next six months • % of employees on temporary contracts because they are unable to find full-time jobs • Job turnover rates	
	Job satisfaction	• % satisfied or very satisfied with their job	
	Autonomy	• % reporting lots of or some autonomy with their job	
	Employee voice	• % reporting they have adequate opportunity to have their views taken into account	
	Opportunities for progression	• % reporting the opportunity to progress in their job • % reporting opportunities to develop their skills	
Environmental impact		• Industrial and commercial CO_2 emissions per full time equivalent job • Overall CO_2 emissions per capita	

- They show which interventions might be most appropriate for each region. For example, the data in Table 4 suggest the North East of England performs badly in unemployment and under-employment. It shows London performs worst in poverty, long working hours, job security and job satisfaction. This suggests measures to increase employment are appropriate for the North East, while interventions to improve wages and job security for those on low incomes are more so in London. The data suggest that fewer interventions might be needed in the South East and South West, which perform relatively well across the whole suite of indicators. This could influence decisions by the national board about where to allocate capital, and influence decisions by regional boards about investment priorities.

- Second, indicators play a symbolic role. For staff, they clarify the purpose of their work; for the public, they clarify the shared objectives of the different agencies working to create good, sustainable jobs. They reinforce co-operation and provide a framework which individual agency performance targets fit into.

- Third, poor performance against these measures may shed light on economic strategy and institutional architecture. If, for example, the BBB appeared to be doing well based on its own PIs, but regional indicators suggested deterioration, this might justify a government review of the BBB's role and how it works with other agencies.

However, indicators measuring the BBB's contribution to these results are also needed. Table 3 displays our initial proposals as a starting point for discussion. All the indicators refer to the aggregate of investee companies in a region. In some cases they are absolute figures, in others changes, and in others absolute figures or changes relative to the regional or sector average. The latter is important because the BBB may be able to promote better than average pay and better conditions in badly paid industries. They are not targets, but form an indicator set that the board and regional boards could use when setting targets – in practice a much smaller set of targets for any year or five-year period.

It could be difficult to gather some of this data, at least without imposing an undue burden on investee companies. This was difficult, for example, with the Regional Growth Fund. So we suggest investigating whether the core employment and pay data could be gathered through (or in parallel with) the PAYE system.

Table 3: BBB short term indicators

<table>
<tr><th colspan="2">Category</th><th>Core indicators</th><th>Supplementary indicators</th></tr>
<tr><td colspan="2">Unemployment</td><td>• Net increase in employees</td><td>• Recruitment of workers under 25 compared with regional average
• Recruitment of long-term unemployed in investee companies compared with regional average</td></tr>
<tr><td colspan="2">Pay/income</td><td>• Median wages compared with regional average
• Median wages of non-graduate employees compared with regional average and compared with sector average</td><td>• Proportion of employees earning less than 75% of national median wages</td></tr>
<tr><td rowspan="6">Job quality (other than pay)</td><td>Working hours</td><td colspan="2">• % working more than 45 hours a week compared with regional average</td></tr>
<tr><td>Job security</td><td colspan="2">• Number of redundancies
• % of employees on temporary contracts
• Job turnover rates</td></tr>
<tr><td>Job satisfaction</td><td colspan="2">• % satisfied or very satisfied with their job</td></tr>
<tr><td>Autonomy</td><td colspan="2">• % reporting lots of or some autonomy with their job</td></tr>
<tr><td>Employee voice</td><td colspan="2">• % reporting they have adequate opportunity to have their views taken into account</td></tr>
<tr><td>Opportunities for progression</td><td colspan="2">• % reporting the opportunity to progress in their job
• % reporting opportunities to develop their skills
• Average percentage pay rise enjoyed by individuals excluding directors</td></tr>
<tr><td colspan="2">Environmental impact</td><td colspan="2">• CO_2 emissions per full time equivalent job relative to sector
• Change in CO_2 emissions per full time equivalent job</td></tr>
</table>

Subjective data about job quality will require a survey, which the BBB can operate (at the government's expense) on all investee companies. Individual company results need not be released to the BBB but could be released to the companies concerned – the BBB only needs aggregated results. In Chapter 4 we argue that much of this data gathering, for example on employee satisfaction, would be useful to employers and could increase productivity.

3.2 Strategic or leading indicators

The BBB's long-term PIs will measure its contribution to industrial strategy, itself designed to increase the number of good, sustainable jobs. Like its short-term PIs, these will be based on regional and national indicators of overall progress (for the same reasons as discussed above).

These should measure:

- employment in targeted sectors and companies
- skills development
- sustainability and environmental performance.

Our initial ideas for regional and national indicators are set out in Table 5. Again, the BBB will not be the only, or necessarily, the main agency responsible but its investment decisions will influence these outcomes. Table 6 sets out initial ideas for measuring the BBB's contribution to regional and national indicators. For example, the BBB may be able to influence how much SMEs invest in skills. It may even, as the KfW does, develop a product that enables it to reap a basic financial return from direct investment in skills development.

nef is planning more work on both short and long-term indicators to be published in summer 2014.

Table 4: Regional good jobs data

REGIONAL GOOD JOBS DATA	North East	North West	Yorkshire & Humber	East Midlands	West Midlands	East England	London	South East	South West	Wales	Scotland
Unemployment Headline unemployment rate (%)	9.8%	8.6%	8.9%	7.7%	8.7%	6.6%	8.5%	6.6%	5.8%	8.4%	7.4%
Youth (16-25) unemployment (%)	26%	23%	21%	22%	19%	19%	21%	16%	17%	24%	21%
% of unemployed who are unemployed for more than six months	59%	51%	51%	47%	55%	49%	51%	46%	49%	52%	50%
Low income households % of working age adults in households where income < 60% of national median (2008-11)	23%	23%	23%	22%	25%	18%	28%	16%	20%	22%	19%
Wages (median hourly wage for all workers in region)	£10.36	£10.51	£10.37	£10.24	£10.45	£10.85	£15.74	£12.10	£10.42	£10.08	£11.13
Median household income (2007-10)	£19,155	£19,987	£19,646	£19,966	£19,859	£22,760	£23,742	£24,765	£21,566	£19,582	£21,480
Working hours (too long) % working more than 45 hours per week	18%	17%	20%	20%	18%	21%	24%	21%	19%	17%	18%
Working hours (too short) % under-employed (seeking longer hours)	11%	10%	11%	11%	10%	9%	10%	9%	10%	10%	10%
Average weekly hours	31.5	31.6	31.6	31.8	31.9	32.5	33.6	32.0	31.0	31.4	31.2
Job security % feeling they will lose job within 12 months	14.1%	13.7%	12.3%	13.5%	11.8%	11.7%	16.1%	12.4%	10.7%	13.4%	11.2%
On temp contract as unable to find full time job	48%	38%	40%	43%	40%	39%	33%	35%	32%	39%	44%
Job satisfaction % satisfied or very satisfied with job	58%	58%	62%	60%	58%	61%	58%	61%	62%	61%	57%
Job autonomy % feeling they have some or a lot of autonomy	60%	61%	60%	60%	61%	61%	66%	65%	66%	56%	60%
Job progression % of people wanting a better job with the same employer who can expect to get one in the next 12 months	36%	42%	37%	36%	36%	41%	50%	42%	40%	43%	38%
Employer provided training % of people wanting job related training who can expect to receive some in the next 12 months	78%	75%	76%	75%	75%	75%	77%	79%	76%	81%	75%
CO_2 emissions Industrial and commercial per capita (tonnes)	5.2	3.4	4.5	3.5	2.9	2.6	2.5	2.5	2.4	5.9	3.6
Total regional CO_2 emissions per capita (tonnes)	9.4	7.8	8.7	8.1	7.4	7.2	5.7	7.1	7.0	10.7	7.5

Table 5: National and regional long-term indicators

Category	
Employment	• Change in employment in target sectors and supply chains (i.e. sectors and supply chains identified as having the potential to deliver good jobs for non-graduates and graduates as part of the UK industrial strategy) • Increase in employment in high growth companies • Increase in exports in target sectors
Skill development	• Skill levels (NVQ) in targeted sectors • Surveys of management in targeted sectors on ability to recruit people with requisite skills • Balance in projected demand and investment in supply of requisite skills
Sustainability	• Absolute levels of, and changes in, carbon (and other environmental) efficiency by sector, compared to international changes and (for regional indicators) national changes in those sectors • Change in employment in sectors which are substituting for environmentally inefficient sectors

Table 6: BBB long-term or leading indicators

Category	
Employment	• Change in employment in investee companies in target sectors/supply chains (i.e. sectors/supply chains with the potential to deliver good jobs for non-graduates and graduates as part of the UK industrial strategy) • Net increase in employment in high growth investee companies • Change in proportion of total employment by investee companies in the above two categories
Skill development	• Proportion of financing used to develop skills • Proportions of jobs in investee companies requiring NVQ3 qualifications and NVQ4 qualifications, compared to regional average
Sustainability	• Absolute levels of, and changes in, carbon (and other environmental) efficiency in investee companies' sector, compared to international levels and changes and (for regional indicators) national changes in agreed comparator companies • Investment in technologies which are increasing environmental efficiency, and in sectors which are replacing environmentally inefficient sectors • Aggregate profitability and profit growth of the bank's investee firms if emissions are priced at target price

3.3 From indicators to targets and rules

Discussion of indicators raises question, such as:

- what should be up to management?
- what should be up to the national and regional boards?
- what should be decided by government?
- and what should be decided by Parliament – i.e. legislated and written into the constitution of the BBB?

The BBB needs a clear and stable mandate, backed up by an equally clear and stable performance indicator framework. Therefore, both the mandate and the performance indicator framework should be entrenched – that is set by Parliament. The BBB should be obliged to publish its results against this framework.

However, it will be necessary to prioritise different aspects of this framework on a yearly and regional basis. The performance framework will help do this. The national and regional boards should use the indicators to set a dashboard of targets for management, with more 'stretch' given to priorities. So, for example, if the data show that unemployment is an increasingly serious problem in one region, unemployment can be prioritised. The range of indicators proposed and the flexibility given to boards mean there are no in-built distortions like, for example, a bias against capital intensity.

The targets also need to reflect a realistic assessment of the counter-factual. For example, in industries where productivity is rising sharply, maintaining levels of employment could be considered an achievement.

Targets may also need to be adjusted if the policies that result from them deter applications from SMEs so that some funds are unallocated, or target returns are not earned. What's more, problems revealed by short-term indicators can inform the direction of longer-term industrial strategy. For example, if there is a coherent plan for developing good jobs in the longer term, which depends on increasing the number of any kind of jobs now (as opposed to good jobs now), that could influence current priorities. On the other hand, if getting to good jobs in the future requires an investment in good jobs now, that could influence priorities the other way. In short, considerable flexibility will be needed.

However, too much flexibility could result in the BBB losing the 'sustainable' and 'good' part of its mandate. The BBB's constitution will need to have constraints built in on setting priorities or adapting the performance framework. There are three ways of doing this:

First, a target profit rate should be set for the BBB as a whole – in terms of 'the return on gilts plus x'. The value of 'x' will involve a trade-off: the higher it is the faster the BBB can grow its capital and thus its activities; the lower it is, the greater the scope to address externalities. It follows that the more initial capital the BBB has, the lower 'x' can be and the greater the scope for addressing externalities. The national board would then set hurdle rates for different types of investment and risk, designed to achieve this target rate overall.

Second, basic rules could ensure none of the BBB's investments reduce the number of good, sustainable jobs. For example, it could be stipulated that all investee companies must pay at least the living wage. Investment in industries identified in the industrial strategy as incompatible with a shift to a sustainable economy (say fossil fuel extraction) could be banned.

Third, limits on the weighting given to particular indicators in the framework could be stipulated – for example, regions where median wages fall below the national level could be obliged to address that as one of their targets. A careful assessment of realistic and acceptable minima would be needed.

Fourth, targets would need to be consistent with national and regional industrial strategies. So they would need to be agreed with the Secretary of State (at national level) and relevant authorities at a local level. The Secretary of State's right to reject national targets should be limited, for example by obliging him/her to present a statement to the House of Commons or relevant councils. Even with these constraints, target setting will involve prioritising outcomes, which makes it political. The national and regional boards should all be democratically accountable. We return to governance in Chapter 6.[*]

3.4 Regional targets and capital allocation

How will regional and national targets be reconciled?

The starting point should be an aggregation of regional targets. Resulting national targets should then be adjusted to take into account national industrial strategy and capital constraints. Revised regional targets can be negotiated accordingly. These outcome targets do not translate directly into regional lending targets, although they may influence capital allocation between regions, or lead to different lending criteria for different regions, concentrating resources in areas where good jobs are needed the most.

This is consistent with both the recommendations of the IPPR and what we found in other countries. The IPPR (Dolphin and Nash 2012) rejects formal regional lending targets, but suggests an approach of "target[ing] lending at a regional level in support of the broader aim of rebalancing the economy away from London and the South East"[68] based on capital allocation. IPPR North and NEFC (2012) take this idea further and recommend a "regional allocation of funds according to a formula that combines population with economic potential". [69]

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* More work is needed on how the BBB should relate to other agencies at a national level, including the Green Investment Bank and the Technology Strategy Board, and BIS.

BOX 8: Geographical targeting by national and regional development banks

The Brazilian Development Bank identifies priority municipalities (poorer ones) and is prepared to fund a larger percentage of an industrial project (70% vs. 60%) in these areas. It also lowers the minimum amount it will lend direct (as opposed to through intermediaries) from USD $5m to USD $500,000.

The KfW offers more generous lending terms on several products to firms located in Eastern Germany and Berlin. It has a special regional promotion programme for investments in weak areas of Germany (assisted areas),[70] but this is not a particularly important part of its activities. (KfW observed that, without placing any specific emphasis on any given region, its loans tend to be reasonably evenly distributed across the country, partly because Germany, unlike the UK, has many regions that are strong economically). Some of the German regional banks have loan programmes that only accept businesses located in certain parts of the region, for example LFA Bavaria. The programmes typically have a specific purpose, such as developing tourism in a part of Bavaria that lacks industry. They offer exceptionally low interest rates. The targeted areas are selected by the EU, which sometimes, but not always, supplies the funds.

The Russian Bank for Small and Medium Enterprises Support offers looser conditions and slightly more generous interest rates in certain geographies, such as remote cities, or municipalities where there is only one major employer.

Among the national investment banks we interviewed, only the Business Development Bank of Canada (BDC) stated that geographical lending targets were important to the way it operated.* It compiles a financial plan every year. Once this national plan has been approved by the government, the bank breaks it down into regional plans, and sets targets for individual managers. It is prepared to increase its risk appetite in areas that are struggling, for example, manufacturing in Ontario, but won't offer more generous loan conditions, e.g. lower interest rates or longer terms. This may be because BDC, unlike most of the banks we looked at, lends directly to businesses rather than through intermediaries. It does so from over 100 business centres, with local staff having substantial autonomy. In this context, regional and local lending targets are useful management tools. (For more on distribution see Chapter 5).

* The Russian Bank for Small and Medium Enterprises Support has regional lending quotas for older programmes. However, there are no regional targets for newer programmes.

Most of the national investment banks we examined target or direct activities geographically to some extent, although apart from the Business Development Bank of Canada, they do not use formal regional lending targets extensively (see Box 8). The Council of Europe Development Bank (CEB) – a multilateral development bank – targets its products in specific geographic regions on the basis of unemployment data to achieve its social cohesion objective. To be eligible for CEB funding, SMEs must be located in regions with an unemployment rate equal or higher to the European average, or be located in one of the CEB's target countries (see Box 9).

In the UK, labour market data (including unemployment, benefit claimants rates, and skill levels) already play an important role in targeting support for business: that is in determining the locations where BIS can allocate business support through the Regional Growth Fund and the Grant for Business Investment Schemes (see Box 10)

Despite all this, it has been argued that regional targets (and the kind of targeting used overseas and described above) are not needed: success for the economy as a whole will translate into success for different parts of the economy. Splendid performance in one part of the country (the South East) cannot conceal relative failure in another (the North East) – or so the argument goes. It follows that the board only needs national targets. However, as we saw in Chapter 2, living standards have risen in some parts of the country and fallen in others. The UK evidence, as well as international practice, contradicts the centralisers' theory.

BOX 9: Geographical targeting by the Council of Europe Development Bank

The Council for Europe Development Bank (CEB) has an objective to strengthen social cohesion. One way it contributes to this is by helping to create and preserve viable jobs –mainly by helping SMEs access credit to acquire or lease fixed assets.

To be eligible for CEB funding, SMEs must be located in a region where unemployment is equal or higher than the EU average, or in a CEB target country. These are predominantly member countries in central and south eastern Europe – most of which have unemployment rates higher than the EU average.[71]

The CEB actively seeks to enhance the support it offers to target group countries, which had a 40% share of CEB loans in 2008. The CEB aims to increase this by 15 to 20 percentage points by 2014.[72]

BOX 10: The Regional Growth Fund and the Grant for Business Investment Schemes (UK)

BIS currently operates the Regional Growth Fund and the Grant for Business Investment – schemes that support the private sector to expand and deliver sustainable jobs. Both schemes give grants rather than loans, and labour market statistics form a key role in determining where support can be provided.

The Grant for Business Investment Scheme is discretionary. It is open to large, exceptional projects which mitigate a significant downturn in the local labour market or address a significant market failure.[73] Grants for this scheme can only be offered to businesses investing in certain areas of the UK, determined on the basis of four labour market indicators: employment; adult skills at level 2 or above; incapacity benefits claimants; and manufacturing as a share of employment. Eligible zones need to either be one standard deviation worse than the UK average on any of these indicators, or half a standard deviation worse than the UK average on at least two.[74] The criteria were established in line with European Commission guidelines by the Department of Trade and Industry (DTI) in 2006, following a public consultation.[75]

The Regional Growth Fund funds projects that help create sustainable private sector employment in parts of the UK that are highly dependent on public sector employment. Labour market statistics form a key part of the assessment process. Indicators include the percentage of residents claiming out of work benefits; public sector employee job share; private sector employee job growth; and the number of active enterprises per 1,000 resident population.[76,77]

4. Putting a good jobs mandate into operation: 2) management tools

This chapter outlines the process that applications will go through and some of the products and processes needed to maximise the broader economic return. We do not wish to create an operational blueprint – within the mandate and targets described in the previous two chapters, the BBB's management should have discretion over products, processes and how the BBB works with other public agencies. Our aim is to demonstrate that putting a good jobs mandate into operation is feasible.

4.1 The division of labour between partner banks and the BBB

Our preferred option, described in Chapter 5, is that the BBB works with local partner banks and therefore we have described the process in these terms – but the account could be adapted to the other options set out there.

Our review of other development banks found that they generally allow local partner banks to assess customers for eligibility, that is, whether they offer the broader economic or social returns required by the banks' mandates. They control the quality of this process by auditing case files after the event. The extent of auditing varies from 100 per cent in the case of some KfW products to merely retaining a right of inspection, as in the case of the Nordic Investment Bank. This appears to work well.

But these banks are working with well established networks of local banks. Simply adopting this process would not be feasible in the UK. So we recommend that, initially, regional offices of the bank – not local banks – should carry out all eligibility assessments. This is because it will take time for local banks to develop the required expertise and the process must be tested and refined before any of it is sub-contracted.

However local banks will be sharing the risk from the start, and will be the first point of contact with the customer. In addition, we assume that local banks will be lending money from sources other than the BBB. So some kind of screening process by the local banks will be needed.

This might be as follows.

A local bank could classify all applications into three categories: outright rejections; those it lends to using funds from other sources; and those it passes to the BBB. The third category will consist of businesses which immediately appear to have 'good, sustainable jobs' features, making them suitable for BBB investment. So they may be granted:

- lower cost finance than other local bank clients
- some risk reduction support from the BBB
- different financing products to those offered to other local bank clients (e.g. mezzanine or equity finance)
- support to make them ready for a loan or other investment.

The BBB's regional office will assess the applications and, where appropriate, provide the local bank with funds to lend. If the product is debt, the local bank will take on most of the risk, with some kind of support from the BBB. If the product is equity or mezzanine finance, the local bank may have to provide the accompanying debt. Where investment readiness support is provided, the business could re-apply and join one of the other categories in due course.

Once this trialling process is complete, and as the BBB grows, and volumes of eligible financing increase, local banks could apply to become accredited distributors of the BBB. To become accredited they would have to invest in the necessary training and systems so they could assess applications to the same standard as the BBB. Accreditation should not discriminate against smaller banks, and challenger banks. This means some applications – such as those for equity investments or those sourced by the smallest banks – might continue to be assessed by the BBB's regional offices.

Accreditation would also need to offer sufficient commercial advantage to banks to incentivise them to invest. This might come through higher success rates (from being more able to match applicants with suitable products); quicker loan application processes; marketing benefits; and potentially, if necessary, fees paid by the BBB. Incentivising banks to invest their human resources in acquiring deeper knowledge of their customers should also create positive externalities, and 'crowd-in' commercial bank investment into their SME distribution infrastructure.

Despite this process of accreditation, to develop the industrial strategy BBB staff must be kept close to the coal face – not just by auditing partner banks' performance, but through regular feedback sessions with loan officers. As we argued in Section 2.4, this feedback into industrial strategy is one good reason for giving the BBB a broader economic mandate. (See sub-section on industrial strategy in Section 4.3).

4.2 Designing the BBB's financing products to help deliver good jobs

Designing a financial product to address a specific need or social objective is one of the most common ways for national investment banks to achieve their overall objectives. Most of the national investment banks and multilateral development banks we interviewed offered different financial products – each directed towards achieving a specific economic or social objective.

The KfW offers products aimed at improving the environmental efficiency of homes and businesses, as well as programmes to support new environmental technologies and renewable energy generation. It has finance products aimed at supporting human capital development, which offer finance to students and individuals undertaking professional development courses, such as training to become master craftsmen. It also offers products specifically aimed at start-ups, SMEs, social enterprises, research and development activities and feature length films.

The Council of Europe Development Bank only offers loans to finance projects in areas associated with its mandate: strengthening social integration, managing the environment, and supporting public infrastructure with a social vocation.[78]

There are several ways BBB products could prioritise the delivery of good jobs as defined in Chapters 2 and 3.

- *Provide financing programmes for sectors and supply chains identified in the long-term performance framework as priorities for the bank (and industrial strategy as a whole)*

  This would directly translate industrial strategy priorities into financing.

- *Provide financing programmes to SMEs with high growth potential*

  Research by NESTA found a small number of high growth SMEs (6 per cent of UK businesses) provided over half of new jobs created by existing businesses between 2002 and 2008.[79] NESTA also discovered that finance is a disproportionately important obstacle for such firms.[80] They are often seen as a higher credit risk by banks than their insolvency rate suggests they

BOX 11: Financing programmes offered by the KfW

Category	Finance products available
Home modernisation and energy conservation	• Loans to make homes suitable for those with limited mobility • Loans for energy efficient construction of new homes • Loans and grants for energy-efficient refurbishments of older residential buildings
Energy efficiency and corporate environmental protection	• Loans for investments in general environmental protection measures • Loans for large industrial projects using innovative environmental technologies for the first time • Grants for SMEs seeking advice on improving energy efficiency
Renewable energy	• Various loan products to invest in renewable energy generation • Specific programmes for deep geothermal energy and offshore wind
Innovation	• Two-part loan programmes for 1) research and development and 2) introduction of new products, processes or services to market
General business finance	• Loans for general capital expenditure and working capital
SME finance	• Equity products • Loans combining senior and subordinated debt tranches to reduce adverse impacts on credit ratings • Advisory services for SMEs running into difficulties but with good overall market prospects
Start-ups finance	• Equity products • Start-up loans (included subordinated debt tranches) for smalls businesses active for less than three years • Grants towards coaching and advisory services
Social enterprise	• Equity products for social enterprises
Regional Ppromotion	• Loans for investments in structurally weak areas of Germany (assisted areas)
Human capital development	• Loans for general student living costs • Loans for extraordinary education costs (such as studying abroad) • Loans for living costs while undertaking an apprenticeship or full-time professional development course
Support for film financing	• Loans for all phases of project development associated with the production of feature length films

should be.[81] Given the potential for such businesses to provide employment opportunities, the BBB could develop financing programmes to support businesses with high growth potential. This would require specialised market and technological knowledge, as well as venture capital skills. These firms are likely to need equity and mezzanine finance as well as debt. Assessment is likely to remain with the BBB's regional offices rather than being sub-contracted.

BOX 12: Specific financing programmes offered by the Council of Europe Development Bank

Objective	Financing activities
Strengthening social integration	• Aid to refugees, migrants and displaced persons (construction/repair of reception structures, preventative and curative medicine, technical infrastructure) • Loans to provide social housing for low-income persons • Financing SMEs in regions where unemployment is higher than the European Union average • Improving living conditions in urban and rural areas
Managing the environment	• Reconstruction projects following natural or ecological disasters • General environmental protection projects • Protection and rehabilitation of historic and cultural heritage (e.g. UNESCO World Heritage sites)
Supporting public infrastructure with a social vocation	• Projects financing health and related infrastructure (e.g. hospitals) • Construction of educational infrastructure • Finance or programmes to provide training for the unemployed or disadvantaged populations • Infrastructure of administrative and judicial public services

- *Provide financing programmes for employers who demonstrate a commitment to improve job quality, within sectors where many non-graduates have 'bad jobs'*

  In a previous **nef** report, Shaheen and Seaford (2012) reported that an increasing number of non-graduates are employed in low-paid, insecure jobs with few opportunities to progress.[82] These sectors include retail, hospitality and social care. The BBB could develop financing programmes for employers in these sectors that have an explicit commitment to improving job quality, particularly for non-graduates. Further work will be needed to develop a methodology for identifying such firms, but identification criteria might include: training and development policies for all employees: wage premiums for employees with basic qualifications: formal structures for involving staff in decision making; and accreditation with schemes that promote best practice in employee well-being, such as the Investors in People 'Health and Well-being Good Practice Award'.

- *Provide financing programmes for employers seeking to invest in projects where a key objective is to provide sustainable employment for the unemployed and long-term unemployed*

  As noted in Chapter 2, unemployment is one of the biggest causes of low well-being. So providing sustainable jobs for those who are unemployed is an important first step to providing them with good jobs. Employers applying for such a programme should be able to demonstrate financial sustainability and how their proposed project will provide sustainable employment opportunities for the unemployed. It is likely that social enterprises will be among those receiving funding for this type of project. Investment could be co-ordinated with grant investment.

- *Provide financing for employers who are investing in improving management practices or developing their provision of job related training*

  Research has found that good management practices are often correlated with employee friendly policies – such as work-life balance – higher productivity levels and improved environmental efficiency.[83,84] Finance is often available for employers to undertake capital expenditure or invest in working capital, but less common for financing programmes that develop management capability, improve HR practices or develop job related training – particularly among SMEs.

  The BBB could offer financing programmes to help employers invest in management practices and/or develop their provision of job related training. The UK Commission for Employment and Skills (UKCES) recently launched a pilot programme for a competitive fund that encouraged employers to invest in current and future employees. Lessons from this pilot would help in the design of these financing programmes.

- *Provide financing to employers who want to improve the environmental efficiency of their operations to the extent not provided by the Green Investment Bank*

  The sector driven policies outlined above should support the development of sectors with good green potential. But it is also important to provide support for employers in other sectors who want to improve the environmental efficiency of their operations. Financing programmes could learn from the environmental efficiency programmes of the KfW. The Green Investment Bank has now identified non-domestic energy efficiency (including building facilities, infrastructure and industrial processes) as an area of operation. Whether a competitive or complementary product would be useful is an open question.

4.3 Including a good, sustainable jobs assessment in all or most financing decisions

An alternative to setting up specific programmes would be subjecting all applications to a 'good, sustainable jobs assessment'. This would result in a score designed to predict the contribution of the potential investee company to the BBB's performance indicators. This could broaden the type of sectors and companies the BBB could support, and help ensure that its funds are not likely to create 'bad jobs'. In practice any such assessment tool will need to be used flexibly – to avoid deterring applications or imposing a burden on applicants.

The costs of assessment also need to be taken into account, although – since the reason for the assessment is to achieve a broader economic objective – the BBB (or partner banks where relevant) could receive a fee from the government to pay for these. Alternatively, any advantage the BBB gets in the capital markets, because of its implicit government guarantee, could pay for this. In any case, costs should not make interest rates uncompetitive.

There are likely to be four main components of any assessment, focussing on: the impacts on employment and pay; other aspects of a good job as described in Chapter 2; immediate impacts on sustainability such as carbon emissions; and on the contribution of the investment to advancing the industrial strategy, including its long-term contribution to sustainability and innovation.

A key challenge will be to identify company specific factors without prohibitively expensive or burdensome data collection. Our research suggests it may only be financially viable to carry out in depth social and environmental appraisals for large investments.

Employment and pay

The framework used by BIS to appraise projects for the UK Grant for Business Investment Scheme (GBI) and the Regional Growth Fund (RGF) could be used as a basis for developing the employment and pay aspects of the assessment. There are some shortcomings to the scheme – notably its failure to prepare a pipeline of applicants, and the sometimes excessively onerous burden on applicants. Streamlining will be essential. In Section 4.4 we describe the consultancy offer the BBB could develop to address the pipeline problem among other things. However with these caveats, a version of the analysis used for the RGF could be useful, at least for larger projects.

When appraising applications, BIS undertakes rigorous analysis to estimate the number of jobs created or safeguarded, and the potential increase in wages (relative to existing jobs) that may result from funding being offered to a project (see Box 13). The BIS framework does not take into account positive employment practices or weight wage premia for low-earners higher than those for higher earners. But it would be possible for the BBB to add these considerations to the analysis.

The key challenge is ensuring that assessments can be carried out in a cost-effective way without imposing an excessive burden on applicants. BIS appraisals for the GBI applications can take several months. BIS has streamlined and industrialised the process for appraising RGF applications, which takes one or two days. But even this would be too resource intensive for both the BBB and applicants when assessing smaller investments.

Further work is needed to see if a cost effective process can be developed. This could exploit economies of scale at a local level that the RGF cannot (because it does not give that many grants in any given area). For example, it should be possible to establish levels of pay and turnover rates for staff with basic qualifications relative to similar firms (in terms of size, sector and geographical location) reasonably cheaply.

The other aspects of a good job

As noted in Chapter 2, in addition to pay, factors associated with well-being at work include job security, opportunities for progression, satisfying work (covering among other things skill use, autonomy, and good relationships with management), decent conditions, and work-life balance. It is easy to obtain and verify financial information associated with investment projects through audited accounts. But it is much more difficult to obtain and verify information on practices associated with well-being at work. Employee surveys may be a useful source of information. But if businesses making applications know the results of employee surveys will be hardwired into the assessment process, they will have strong incentives for misreporting. (This does not mean that post-investment surveys may not be useful: see 4.3 below).

BOX 13: Labour market analysis in the UK Grant for Business Investment and Regional Growth Fund Schemes

BIS currently operates and/or administers a number of schemes that provide regional support, including the Grants for Business Investment (GBI), the European Regional Development Fund (ERDF) and the Regional Growth Fund (RGF). (See also Box 10.)

The Grant for Business Investment (GBI) scheme is discretionary and provides capital grants to businesses to support investment in England. Projects are typically large (the grant needs to be £2m or more, and typically provides 10%-15% of total eligible capital expenditure). Projects must either mitigate or avoid a significant downturn in the labour market or address a significant market failure – for example research and development (R&D) spillovers, skill enhancement, wider economic benefits. To comply with State Aid rules, the funding is only available for English Assisted areas. The assessment process is quite involved. It takes several months to do the value for money assessment based on social returns.

The Regional Growth Fund is a £2.4bn fund which seeks to lever private investment, particularly in areas and communities that have depended on the public sector for employment. Funding is allocated in competitive rounds with many hundreds of applicants. Assessments are done in a more industrialised fashion than with the GBI scheme. There is a minimum grant size of £1m, which lends itself to a minimum project size of £5m.

Applications in both schemes undergo a thorough assessment process, where BIS officials seek to understand the base case scenario (without investment) and the additional benefits that may arise as a result of support. The core of the analysis is the impact on the labour market: creation of new jobs; safeguarding existing jobs; and increase in pay over alternative jobs. This takes into detailed account the skill profile of jobs created as a result of the proposed investment project; the impact on the supply chain and the local labour market conditions; and the likely impact on unemployment. The analysis also tries to take into account externalities (such as skills and R&D spillovers), and consider the option value associated with any investment. The process takes one or two days.

Other information that helps identify practices associated with good jobs may include:

- *Accreditation with schemes associated with improving well-being at work*

  Several accreditation schemes are associated with improving well-being at work and require organisations to be assessed. Accreditation with such schemes (or demonstrable evidence that an employer is working towards achieving accreditation) may demonstrate good practices and a commitment from management to improve the well-being of employees. The Investors in People 'Health and Well-being Good Practice Award' assesses how supportive an employer's management and culture are; stress management; work-life balance; and policies to improve health and well-being. Assessments are carried out by interviewing representatives across the organisation.

- *Spending on staff training and development*

  High levels of spending on job-related training and development may also indicate that an employer is seeking to provide good jobs. While spending on training and development may be externally verifiable, the danger is that including this variable into the assessment framework may cause changes in the way in employers record activities.

- *HR policies, employment terms and contracts*

  It may be possible to derive verifiable information about work practices by examining HR policies and employment contracts. Factors that indicate a management culture with poor commitment to improving employee well-being include: large numbers of staff who have opted out of the 48-hour working limit; and a high number of workers on temporary contracts who do not have advanced qualifications. HR policies that require regular staff appraisals, goal/objective setting and that support flexible working indicate a company is supportive of employee well-being.

BOX 14: How European multilateral development banks consider the environmental impact of their projects

The Council of Europe Development Bank, European Bank for Reconstruction and Development, European Investment Bank, the Nordic Environment Finance Corporation and the Nordic Investment Bank have all signed up to a common approach to environmental management associated with financing projects. This is based on the environmental principles, practices and standards of the European Union.

Compliance with the European Principles for the Environment requires all the multilateral development banks to conduct a review of loan applications, typically involving:

- categorising projects according to their potential environmental impact
- defining the risk and impacts of the project, and of planned mitigating measures
- benchmarking the project's environmental and social performance with relevant standards
- assessing the commitment and capacity of the client to manage these potential impacts
- verification that the costs resulting from the environmental and social risks are factored into the project.

The scope and information requirements of the review generally depend on the scope of the environmental impact. Projects with the potential for an extensive environmental impact require an extensive environmental impact assessment, before a decision is made. If the initial scoping exercise concludes that a project is likely to have minimal environmental impacts, there is no need for a formal environmental impact assessment. SME financing often falls under the latter category.

When loans are carried out by financial intermediaries on behalf of the multilateral development banks, environmental impacts might be assessed by the financial intermediary of the multilateral development bank. This depends on the capacity of the intermediary to assess environmental and social risks, and environmental impacts associated with its investment activities.

Many of many multilateral development banks expend considerable resources on environmental and social impact assessments. The European Investment Bank, for example, has 300 engineers and economists who screen projects before, during and after lending.

Other national investment and multilateral development banks do not use employee-friendly employment practices as indicators to assess loans. Most of the multinational development banks include social and environmental impact assessments in their project appraisal processes. But employment considerations are normally limited to ensuring compliance with international labour standards (i.e. International Labour Organisation standards and European Union regulations) and the number of jobs that might be created. A more elaborate assessment may not always possible, but an obligatory minimum standard could be formed using international labour standards and including the rights to organise and to collective bargaining; payment of the living wage; and a ban on black listing employees engaged in union activity.

BOX 15: How the Nordic Investment Bank trades off its environmental objective against its competitiveness objective

The Nordic Investment Bank assesses all projects on how consistent they are with the two objectives in its mandate: strengthening the competitiveness of its member countries and enhancing the environment. This in on top of all projects having to comply with the European Principles of the Environment.

Analysis on contributing to the environmental enhancement objective typically goes beyond the requirements of the European Principles for the Environment. It draws on historical environmental performance data accumulated by the Nordic Investment Bank over many years of carrying out operations.

Each potential project is rated on both competitiveness and environmental mandates on a scale running from positive to negative. Consideration is given to implementation risks. The board then takes a vote on whether to go ahead with a project based on the scores and other information available. It is possible for the board of the Nordic Investment Bank to go ahead with a project that is potentially good the environment, but neutral or negative for competiveness and vice versa.

Sustainability

The BBB might also use the practices of multilateral development banks for appraising environmental impacts as a basis for the environmental aspect of a good job assessment. (See Boxes 14 and 15.) Some of the techniques developed by the regional development agencies (RDAs) may also be useful and should be investigated. This may be too costly for smaller projects, so the challenge is to use readily available data to create a streamlined process.

nef is currently doing further work in this area, linked to its investigation of suitable short and long-term performance indicators as referred to in Chapter 3.

Industrial strategy

Once sectors and supply chains have been identified as part of an industrial strategy, it will be relatively straight forward to assess whether an investment will increase employment in a prioritised sector or supply chain. Similarly, it will be relatively straightforward to assess companies' skills plans (and then monitor performance against this) or the proportion of employees needed to be at NVQ3 and 4. As noted above, assessing whether companies are 'high growth' will require specialised market and technological knowledge as well as venture capital skills. Such assessment could be sub-contracted to the private sector (if the co-investment model is adopted) but further work is needed to assess whether this is the right approach.

An industrial strategy is not a static plan. As our work in the summer of 2012 on the economy of the North East made clear,[85] while there are some sectors which can be easily identified as offering potential (automotive supply chain, off-shore wind), other sectors (technologies to deal with aging) that merit support may emerge more unexpectedly.

When the bank receives applications from firms in sectors or supply chains that have the potential to supply good jobs in the future (so merit co-ordinated support across agencies), it will need to make a strategic assessment of this potential. It may need to review this with other agencies involved in developing the industrial strategy for the region (or the country as a whole). This is in effect revising the industrial strategy in real time.

This might be based on three elements:

- a fairly standard market, technology and competition analysis
- a good, sustainable jobs assessment of the kind described in this section
- and an examination of the impact on other businesses, through the supply chain, cluster effects, skills development, critical mass effects and so on.

We recommend that the bank becomes the main repository for this type of expertise and that the sub-contracting process described in Section 4.1 is designed to ensure this.

4.4 Introducing new products and tools that would help firms deliver good jobs

Consulting services

Recent research suggests management practice could be a very important factor in explaining productivity differences across different countries.[86] The UK has a much higher percentage of poorly managed manufacturing firms, many of which are small or family managed. Research by the same authors found interventions – in the form of consultancy – helps improve management practice and productivity.[87] Other research found good management practice is correlated with employee friendly policies (such as flexible working)[88] and increased environmental efficiency.[89]

So it is not surprising that several national investment banks (including the KfW, the Business Development Bank of Canada and the US Small Business Administration) provide consulting services to complement their financial offerings. This clearly reduces the failure rate of investee companies. Consulting services are often provided on a grant basis (KfW), or on a subsidised basis (BDC). The UK government may also integrate its current business support offers into the BBB.

In addition, the BBB may need a more proactive investor readiness programme. (We understand this sort of scheme may have already been introduced by some local authorities.) Investor readiness may be particularly important for equity investments. Our review of the North East economy (conducted in the summer of 2012 for the Good Jobs Taskforce) concluded the 'finance gap' could be as much about the demand for, as the supply of, finance. An expert paper by Professor Colin Mason of the University of Glasgow, submitted to the North East Independent Economic Review, concludes "across the board supply-side policies involving an increase in publicly supported venture capital funds will be ineffective, at least without a significant complementary to promote entrepreneurial activity. The North East, like other regions, simply lacks the absorptive capacity to productively invest significant additional finance".[90] In other words, managing the pipeline will be critical.

If the BBB offers consulting and advisory services to complement its financing activities, it could include employee well-being advisory services within the portfolio of offerings. It could also ensure that staff are trained to identify possible improvements to employee well-being practices while carrying out their consulting assignments.

We are not proposing that the BBB necessarily provides these services entirely in house. To a large extent it could act as a referral and quality control service.

Employee well-being at work surveys

In Chapter 3 we suggested that the BBB could conduct employee surveys in its investee companies. It could build on this by either offering the results to companies, or requiring them to receive the results and produce a good job development plan based on the findings. One way of encouraging SMEs to take this practice seriously would be to increase interest payable (loan recipients only) if they fail to produce such plans.

4.5 Government grant making

The BBB could be responsible for allocating grants to businesses as well as for investment and managing government and EU funds for a fee. This would be in line with current plans to turn the BBB into a one-stop shop for SMEs. In Chapter 2 we argued that investment decisions should not just be financial but take broader economic returns into account. In Section 4.3 we suggested that the BBB could in some circumstances use the same techniques as BIS to assess grant applications. The logical next step is to suggest that BBB could be responsible for grant making as well as loans and equity investments.

Co-ordinating the allocation of grants and investment has advantages. For example, grants may be appropriate to support innovation in a company at an early stage, but the same company may need access to equity or debt later on. It makes sense for these to be handled by the same organisation. This would also help streamline the interface between different forms of government support and business. There might be cases where grants to reduce unemployment could be linked to investment. The Industrial Development Advisory Board, which currently advises BIS on major grants, could advise the bank.

4.6 Providing performance incentives to management and staff on the basis of good jobs data

Most of the recommendations so far in this section have been indicative: ultimately it is for the management of the bank to design products and processes which deliver its mandate. No doubt their primary motivation will be a personal and collective commitment to the objectives expressed in that mandate.

However, it would be possible to reinforce this motivation with performance incentives for both management and staff, based on the kind of indicators described in Chapter 3. The size of the staff motivational budget or overall bonus pool could be linked to these indicators. This could be done at a national level, but regional indicators could also be used to determine rewards for teams responsible for specific regions. This would of course have to be part of a fair and transparent reward system, preferably agreed with the trade union.

Of course, performance against these targets is not entirely or even largely within management or staff control. But this is true of many outcome indicators, including public company share prices.

There is also the question of whether bonuses should be paid in any public sector institution. There are, of course, concerns that such an approach might be unfair and ineffective. Monetary incentives might have an adverse effect on intrinsic motivation or they might encourage gaming. A recent review of the literature on performance related pay in the public sector was inconclusive. It suggested it can improve outcomes where performance is easy to observe, such as schooling, healthcare or tax collection. But there is limited evidence that it affects performance in organisational contexts where measuring outcomes is complex or difficult.[91] Moreover, the authors noted the studies that found positive results were often short in length, so it is possible that positive results will disappear once staff are familiar enough with the incentive scheme to game it.

However, if bonuses are paid, linking them to performance could help avoid a situation where the public are experiencing lower job quality and satisfaction, while bonuses paid to public sector bankers are going up. Bonuses could also encourage innovation in difficult areas, such as the non-pay aspects of job quality.

5. Distributing the bank's products

The mandate and performance indicators we have recommended do not suggest the BBB should only lend to SMEs. But the work others have done – and international experience – shows these will be an important part of the market. SMEs, in particular, will be difficult to reach. In this chapter we look at how publicly owned investment banks around the world have addressed this problem, and draw up a set of options for the BBB. (For summary descriptions of these banks see Boxes 17, 18 and 19). A separate question (which we have not yet addressed) is the extent to which co-investment in private sector equity funds is the best approach to equity investment.

Broadly there are two models: direct lending and investment, and lending via intermediaries, most typically on-lending, i.e. lending to financial intermediaries, such as banks, on the understanding that these funds will then be lent out to, say, SMEs. A variation on the latter is to provide guarantees to encourage lending. Some banks make major investments directly, and loans to SMEs through intermediaries.

As we will see, direct lending requires a local branch network. Lending through intermediaries tends to depend on a local (as opposed to centralised) banking sector. This creates a dilemma for the BBB since there is no UK local banking sector.

5.1 Direct lending and investment

The national investment banks that primarily lend directly include the Business Development Bank of Canada (BDC) and the Japan Finance Corporation (JFC). The Brazilian Development Bank (BNDES) does both direct lending and on-lending, but only makes direct loans to private enterprises of more than $5 million. It relies on commercial banks to distribute smaller loans.

Of the BDC's funds, 98 per cent are lent directly, with the other two per cent typically invested in venture capital funds. (The bank often co-finances alongside other financial institutions). The BDC argues that relying on other banks to distribute loans may work when times are good, but is liable to break down during a financial crisis, when banks are reluctant to lend regardless of sweeteners. It maintains it was better at getting loans out to SMEs during the financial crisis than many other national investment banks.

The banks we surveyed that do direct SME lending have extensive branch networks. The BDC has 106 branches, and the JFC has 153 domestic offices and two overseas ones. These large branch networks are unsurprising given the importance of branch access and local knowledge for SME lending. (See 5.5 below and Box 3 above on the Small Business Taskforce's recommendations). They also enable both the BDC and JFC to provide other important services, including consultancy. It is expensive to create a large bank network and assess individual SME loans, but the BDC argued strongly this is the best way in the long-run.

5.2 On-lending

KfW, the Russian Bank for Small and Medium Enterprises Support, and the Nordic Investment Bank primarily practice on-lending for SMEs. German state banks also tend to do on-lending for private enterprise financing, both for SMEs and larger corporations.

BOX 16: Auditing and control

While they do not take on the risk, the state banks overseas will typically set key parameters, e.g. the maximum credit line it is prepared to have with any given bank; key criteria that the business benefitting from the loan must meet; and the maximum exposure that a participating bank can have to any one business. It will then engage in an audit to ensure that money is being used as agreed.*

KfW has the most intensive audit process of the promotional banks we looked at. It examines all the SME loan applications after they have been approved by its banking partners to check that every loan meets the eligibility criteria. The bank acknowledges that this causes substantial additional costs, both in terms of time and resources, and so puts a constraint on the minimum size of the SME loan that KfW funding can support (EUR 10,000). However, this is still a relatively small loan for a business, and so this restriction does not seem problematic.

In contrast, the Nordic Investment Bank has the most relaxed audit process of the promotional banks we spoke to. It requires its banking partners to submit annual reports detailing the improvements their loans have made according to an agreed list of indicators (for example, the amount of carbon emissions saved as a result of their lending). It does not check whether its banking partners lend the money to enterprises that fit the agreed loan criteria. It does, however, reserve the right to request such information.

* For example, once a year BNDES will randomly select a sample of its partner banks' clients to check that its partners have not lent inappropriately. Similarly, the Russian Bank for Small and Medium Enterprises Support audits its banking partners and a select group of the end-user SMEs. Its banking partners also have to provide it with monthly updates on what projects they have lent to, and at what interest rates. Every two years LFA Bavaria will visit its partner banks and look over the documents it has on SME monitoring.

When engaging in on-lending, a state investment bank will lend to other banks on the understanding that funds will be lent on to whatever type of business the state bank is targeting, e.g. SMEs or renewable energy providers. Typically the state bank can borrow at government borrowing rates, enabling it to provide below-market rate loans to other banks.

As the other banks do the risk assessment, the state investment banks do not need an extensive branch network. For example, KfW has only three branches and the Russian Bank for Small and Medium Enterprises Support and Nordic Investment Bank have only one office each. Similarly, German state banks tend to have just one or two offices.

In most cases the state bank is only exposed to the risk of its partner banks defaulting: the latter shoulders the risk associated with the business loans themselves. The Russian Bank for Small and Medium Enterprises Support and the Nordic Investment Bank operate according to this model. However, in some cases the state bank takes on some of the loan risk. For example, BNDES sometimes shares the risk on large infrastructure projects. Similarly, LFA Bavaria, a German state bank, will sometimes take between 50–80 per cent of the SME risk (EU rules forbid it from holding more than 80 per cent of the risk). KfW takes on up to 80 per cent of SME risk in a small (5–10 per cent) proportion of its portfolio, usually for risky business such as start-up lending. It also ran extra risk-sharing loan programmes during the financial crisis, when it was felt banks needed greater incentives to lend. Otherwise it is only exposed to the risk of the intermediary defaulting.

5.3 Guarantees

A variation on on-lending is providing guarantees for SME loans. The US Small Business Administration (SBA) provides an example.

When the SBA was first established in 1953, it carried out direct lending, and was considered to be the lender of last resort. Applicants were only allowed to apply if they had been turned down by one (or in some states two) commercial banks. However it stopped doing direct lending in 1996 as it was cheaper to issue guarantees, which also allowed more lending to take place with fewer resources.

With the SBA's guarantees, when a loan recipient defaults, recoveries are split between the lender and the SBA. When guarantees were first introduced, the SBA provided a 90 per cent guarantee. However, the level of guarantee provided has changed over time in response to the political scene, financial health of the institution, and lenders' demands. Currently, the standard guarantee for the SBA's main loan programme is for 70 per cent of the loan. However, there are other programmes where the guarantee is as low as 50 per cent. Finally, for particularly important programmes, such as those introduced in response to a crisis, the guarantee provided can still be as high as 90 per cent.

The SBA's guarantees are conditional on the lending institution carrying out its duties properly. Once a default takes place, the SBA investigates and carries out due diligence. If it turns out the bank has not carried out its duties properly, it will not receive payment. The SBA also has the power to demote the lender's status within the hierarchy of SBA lenders or ban the lender from issuing guaranteed loans.

The Japanese Finance Corporation (JFC) also provides guarantees, and similar services are provided by regional state banks in Germany and Russia.

5.4 What kind of banks do state investment banks work with?

State investment banks work with all kinds of commercial banks, but especially with small, localised banks – not as a matter of policy but due to their strength in SME lending. KfW works with nearly every German bank. However, it explained to us that savings banks (Sparkassen) and co-operative banks are "very strong at SME lending due to their local structure". So the majority of KfW's lending goes through these institutions. The precise breakdown, however, was not publicly available.

Among regional state banks in Germany, NRW.Bank said it doesn't discriminate against or favour any type of bank but it mostly works with Sparkassen, because German SMEs tend to use Sparkassen for their financing needs. Similarly, LFA Bavaria said that, while it is not allowed to favour working with one type of bank, it does most of its SME business with Sparkassen, because the latter dominate SME lending in Germany.

Approximately 75 per cent of the Russian Bank for Small and Medium Enterprises Support loan portfolio is with commercial banks. The other 25 per cent is with leasing companies and microfinance institutions. The bank works with 150 small and regional banks but with only two large commercial banks. The other large banks are less interested in SME lending and find it easier to access finance than smaller banks.

The Nordic Investment Bank (NIB) reported that it mostly lends to SMEs via smaller banks, such as public savings banks, although it does work with a few larger banks. It explained that local banks are particularly good at SME lending and place a strong emphasis on this market. However, it does not have a deliberate policy to favour local banks, they are just better suited to the financing and ultimate lending. For example, the NIB asks to see a credible pipeline of potential loans before it will extend a line of credit to a bank. During this process it looks at how well the bank's client base fits its mandate.

Although the BDC largely lends directly, in more remote areas of the country it uses on-lending. It works extensively with Community Futures Development Corporations (CFDCs) in rural regions. CDFCs are small institutions that provide SME loans, consultancy services and work to strengthen local economies. They have distributed \$468m of BDC loans over the past five years, and the BDC has a relationship with 85 per cent of the 268 CFDCs in Canada.[92]

The JFC, another direct lender, will also sometimes collaborate with other banks. For example, Its Micro Business and Individual Unit collaborates with 418 banks to encourage Japanese banks to develop knowledge of and relationships with start-up companies. This typically involves JFC providing part of the loan and other banks providing the remaining financing. JFC works primarily with small banks – 60 of the 107 regional banks, 231 of the 271 credit unions and 125 of the 158 co-operatives. It works with two of the five large commercial banks.[93]

5.5 Local banks and SMEs

The pattern described in the previous section raises the question: why are small banks good at SME lending?

Arguably, large banks lack the incentives to engage in the expensive process of assessing the viability of lending to small businesses – whereas small banks have no choice. This lack of incentive has driven and been exacerbated by the demise of 'relationship banking' and the rise of centralised credit decisions. As the other reports we summarised in Chapter 1 noted, national banks are no longer local institutions that intimately know local people and the local economy. In search of cost efficiencies national banks have relied less on local managers and more heavily on formal 'credit scoring'. In the UK, where business lending is dominated by four commercial banks, failing to meet credit scoring thresholds is the most common reason why SME loans are rejected. Approximately 40 per cent of loan applications fail as a result of this.[94] In addition, the majority of rejected loan applications that are overturned in favour of the customer during formal appeal processes, are done so on a basis of unreasonable credit scoring.[95]

High amounts of collateral are also often demanded. This allows the bank to avoid taking a view on the customer's future prospects, as holding collateral significantly reduces the risk the bank is taking. It is also frequently argued that large banks do not take the time to work with their small business customers, to help them understand what information they need and why their application may have failed.

On the other hand, evidence suggests small banks are better at seeking and assimilating the 'soft' information needed to assess the prospects of small firms.[96] Perhaps as a result, large banks appear to lend proportionally less to SMEs than smaller banks.[97] This may be why 80 per cent of medium and 58 per cent of small Swiss enterprises have a relationship with their local savings bank. And it may be why the equivalent figure for SMEs in Germany is 75 per cent.[98] So, local banks have an intimate knowledge of local people and the local economy, which gives them an informational edge over large centralised banks in the market for small business lending.

The data available on co-operative banks in Europe – which typically operate as collaborative networks of autonomous local banks – corroborates this picture.[99] Table 7 shows that co-operatives, in five out of seven of the profiled countries, punch well above their weight when it comes to SME lending.

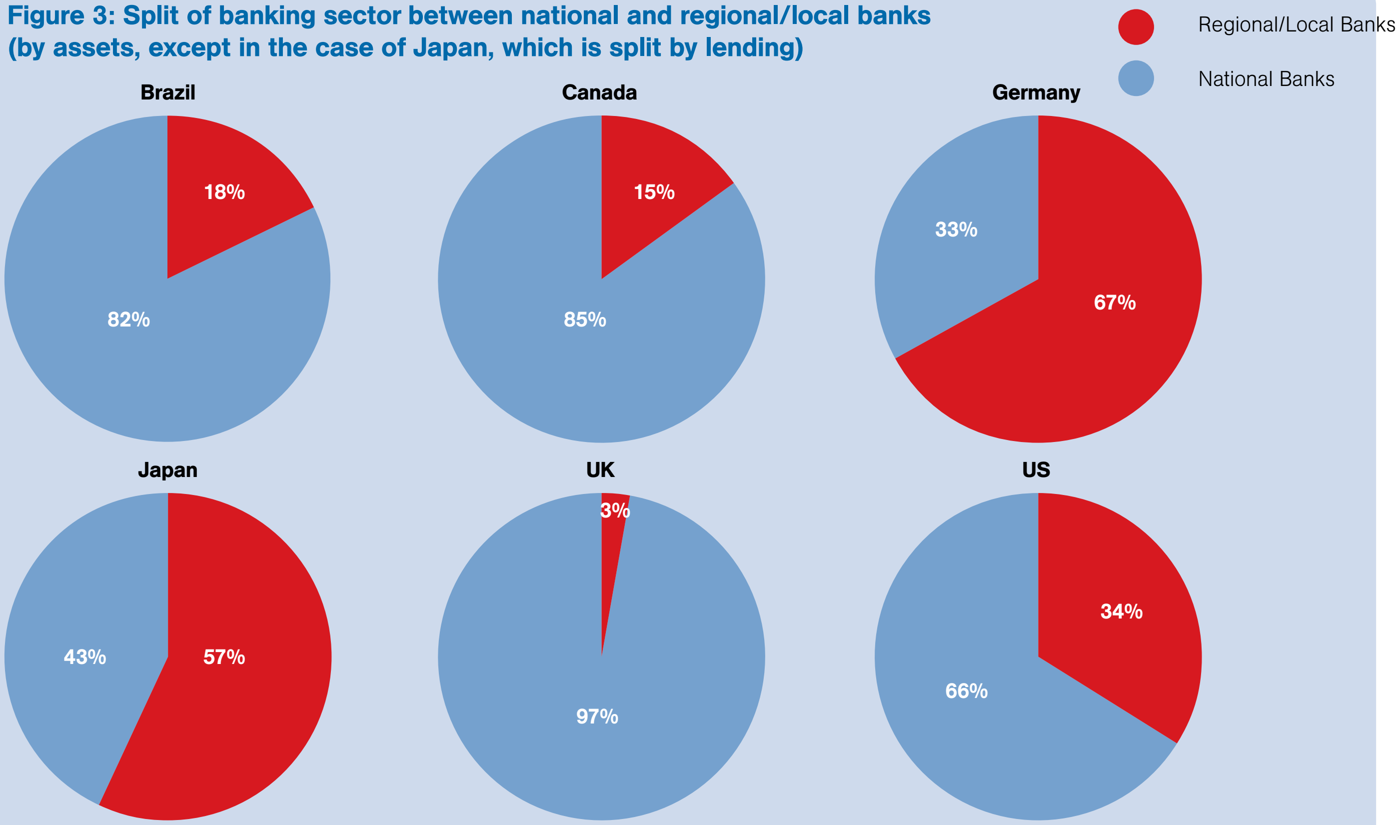
The best performing co-operatives are in Austria and the Netherlands. The two Austrian co-operative networks are together responsible for 46 per cent of all SME lending (versus 33 per cent of all loans). Rabobank in the Netherlands is responsible for 43 per cent of SME lending (versus 29 per cent of all loans). The underperformance in the UK is probably because the branches of the Co-operative Bank are not autonomous local banks but rather branches, like those owned by the commercial banks. What is more, studies in Italy and Germany have found that local co-operative banks help reduce 'capital drain' to urban centres and in turn regional inequality – mostly probably because of their strong SME lending.[100,101]

Table 7: Co-operatives' market shares of loans and SME loans in seven countries in 2010

	Market Share of Loans (per cent)	Market Share of Loans to SMEs (per cent)
Austria	33	46
Denmark	1	1
Germany	17	28
Hungary	3	8
Netherlands	29	43
Portugal	3	5
UK	2	1

Source: European Association of Co-operative Banks[102]

Figure 3: Split of banking sector between national and regional/local banks (by assets, except in the case of Japan, which is split by lending)



Source: ***nef*** *calculations using central bank data, IMF research, banks' annual reports and data provided by industry trade groups*

Many may find these statistics surprising given smaller banks' apparent lack of economies of scale. But small banks typically operate in decentralised networks with central and/or regional institutions to pool services, such as inter-bank lending and liquidity management. This gives them economies of scale.

Figure 3 above shows that, in comparison to many of the other countries we have looked at, the UK has no local banking sector to speak of. This contrasts starkly with Germany and Japan, where the majority of banks are local. However, the UK also falls significantly behind countries such as Brazil, where 18 per cent of banks by assets are local. This will have implications for how a BBB should distribute loans.

5.6 Options open to the BBB

If international experience is anything to go by, the BBB can either set up its own branch network – the direct lending option – or it can work through banks which are capable of lending to SMEs, in which case it does not require its own branch network.

At first sight, the first option looks very expensive. But the trouble with indirect distribution is that it does not tackle the problem the bank is designed to solve, that is, the absence of a banking network that lends to SMEs. The 'Macmillan Gap' problem – the information asymmetry – exists partly because no local loan officer or fund manager can make an adequate assessment. The problem is not lack of funds in the wholesale market but the lack of a suitable distribution mechanism.

Our research shows that local banks – set up to serve a specific geographical area, either by choice or as defined by their legal constitutions – are most effective at distributing the products of state development banks, particularly to SMEs.[103] It is these banks that, almost uniquely among our industrial competitors, are lacking from the UK banking industry.

In theory the BBB could on-lend through the existing commercial banking network (as the Government and the IPPR have suggested). It would incentivise large banks not just to distribute its products, but develop the kind of infrastructure (i.e. the bank managers with adequate training and discretion) needed to do so. These incentives

BOX 17: Descriptions of a sample of national investment banks

Name	Country	Total balance sheet	Product mix	Ownership model
Business Development Bank of Canada (BDC)	Canada	$17.7bn	Loans, subordinated loans, consultancy, investment in venture capital funds, securitisation. For example, the BDC was given a specific mandate during the financial crisis to use a pool of capital to securitise car leases. It has the legal capacity to offer guarantees, but does so rarely.	100% government owned
Brazilian Development Bank (BNDES)	Brazil	R$ 625 bn	Loans and some equity (seed funding, venture capital and private equity).	100% government owned
Japan Finance Corporation (JFC)	Japan	¥30,019.5 bn	Loans, buying corporate bonds, consultancy, securitisation and guarantees.	100% government owned
Kreditanstalt für Wiederaufbau (KfW)	Germany	€494.8 bn	Loans and a very limited amount of grants.	80% owned by national government. 20% owned by the regional governments. KfW explained that it was natural that the states would have a stake in the bank, due to Germany's strong regional history. In other words, it is normal in Germany that the state have a lot to say in national matters.
Russian Bank for Small and Medium Enterprises Support	Russia	RUB 90 969 mn	Loans	100% owned by Vnesheconombank, which is 100% owned by the Russian government.
Small Business Administration (SBA)	US		Predominantly guarantees, some micro loans and disaster assistance loans, and a small amount of equity finance. It also helps secure procurement contracts for small businesses, does advocacy work to champion small businesses' interests in Capital Hill, provides consultancy services, and acts as an ombudsman when small businesses feel they have been treated unfairly.	100% owned by US government (is a government agency)

BOX 18: Descriptions of a sample of supranational promotional banks

Name	Country	Total balance sheet	Product mix	Ownership model
Council of Europe Development Bank	40 European member states	€26 083 mn	Loans	100% owned by its member governments. Ownership is split in proportion to the amount of equity each country put into the bank.
European Investment Bank (EIB)	EU member states	€471 848 mn	Loans	100% owned by EU member states
Nordic Investment Bank	Denmark,	¥30,019.5 bn	Loans, buying corporate bonds, consultancy, securitisation and guarantees.	100% government owned

BOX 19: Description of a sample of regional promotional banks

Name	Country	Total balance sheet	Product mix	Ownership model
LFA Bavaria	Bavaria	€21,945 mn	Loans and has some subsidiaries that do some equity investment in SMEs.	100% owned by regional government
NRW.Bank	North Rhine-Westphalia	€152,546 mn	Loans and a little bit of equity. Seeks to mobilise EUR 4 of private capital for every EUR 1 of equity it invests.	100% owned by regional government

might be based on regional lending and investment targets as described in Section 3.4. Many of the national development banks we examined did use centralised networks to distribute products to some extent. But the general pattern is lending through local banks. Even BDES has a significant local banking sector (18 per cent share compared to the UK's three per cent). We believe relying on the UK's centralised networks would be at best a risky strategy.

So the broader question is how to create a banking sector that can lend to SMEs.

In fact, the UK does have a very small community finance sector, which consists of credit unions, community development finance institutions (CDFIs), a few small building societies and the one remaining independent trustee savings bank, the Airdrie Savings Bank. One route to a local banking sector could be to develop what there is. We suggest that the existing government objective of promoting diversity, choice and competition in the retail banking industry requires policies to grow these sectors.

However, these institutions remain atomised and have never established the networks that allow local finance to flourish in places like Canada, the US, Germany, Australia, South Korea and France. Given their prevalence elsewhere, we doubt that the UK will succeed in scaling up the community finance sector without concerted policy effort. There is some government support for the development of a collaborative central infrastructure to serve a network of independent local financial institutions. For example, under its Credit Union Expansion Project,[104] the Department of Work and Pensions awarded a £38m grant to the Association of British Credit Unions. But this is just for credit unions. And even with this initiative it will take many years, possibly decades, for the sector to reach a scale comparable to that of national commercial banks. Furthermore, most of the sector caters for personal, not business, banking. It will take time to develop the experience and skills needed to cater for the SME market.

A second route would be to create new local banks, or encourage their creation with regulatory incentives. This might go the same way as recent changes in regulatory requirements that tried to correct a bias against new and smaller banks by reducing capital and liquidity requirements, and speeding up the process.[105] Further concessions could be designed for new banks that agreed to:

- adopt a limited business model that focuses on retail banking
- incorporate a specific geographic area in its constitution
- and use the services of an approved central services provider.

The reason for specifying use of a central services provider is that networked systems enable local banks to achieve the economies of scale needed to compete with large national banks.[106] The UK does not presently have such banking service providers. Although we are aware of at least one seeking to enter the market on commercial terms to serve new challenger banks, some government or regulatory assistance might be required to build central infrastructure if local banks are to rival those that exist in other countries. The Small Business Taskforce's proposal for creating a network of new local banks, called Sparks, aims to overcome this problem (see Box 3). It is a well developed version of this second option.

Both the scaling up of the existing community finance sector, and incentives and support for new local banks, are policies that are worthwhile in themselves. The flaw with both of them is they cannot guarantee a new network of local banks that covers the whole country, and they will not deliver it any time soon.

A third route to a local banking sector can guarantee national coverage at scale and at speed, however. In RBS we have a large publicly owned bank. Over 2008-09, as a result of the need to recapitalise the bank, the government built up an 82 per cent stake for a cash investment of £46 billion. Market conditions mean that selling it back to private ownership in the foreseeable future will result in a loss for the tax payer. This presents the UK with a genuinely unique opportunity to ask whether alternatives to privatising RBS in its current form, might create more value for the UK over the longer term.

With its extensive branch network, a significant share of the retail business banking market, and large existing customer base, there are numerous possibilities. For example, could all or some of it be broken up into a network of independent but collaborative local banks, either publically or co-operatively owned? Central infrastructure, such as IT systems and access to the payment systems, could remain centralised, as is the case with the German Sparkassen. But autonomous, local, decision making would hand power back to branch managers, who have more incentive to know their area than either credit-scoring computers or remote head office managers. The BBB could then use this network in the way the KfW uses the Sparkassen.

Of course, extensive research is needed to assess the viability of this option. In particular, the question of ownership of the restructured UK retail arm of RBS is one that requires a degree of sophistication when calculating costs and benefits. One legacy of the past 40 years of political economy in the UK is that there is still kneejerk support for privatisation in all circumstances, especially in banking. But many of the local banks we studied have a dual social and financial objective. Such stakeholder – as opposed to shareholder – banks usually have either co-operative ownership or a constitution that gives them a public interest mandate. In the UK (parochially and in contrast to international evidence) there is a presumption that such banks are inefficient, economically distorting, or badly managed (see Box 20). This presumption must be resisted if we are to make the right long-term choices for the British economy.

Box 20: Is a local public banking sector inefficient?

Before the financial crisis, publicly owned banks came under heavy criticism for not being fully subject to the discipline of the market. In addition, because they are not solely focused on profit maximisation, they were criticised for not having a single, easily measurable target to drive efficiency in the organisation. It was also said that because stakeholders, including governments, on the supervisory boards of these banks did not have any claim on profits generated, they did not have sufficient incentive to ensure capital was used in the best way.

During the financial crisis, public banks in many countries have been able to step-up lending while commercial banks have been withdrawing credit. So these criticisms have begun to fade away. Moreover, as the commercial banks' profit maximisation model was what caused the financial crisis, the 'efficiency' of their approach is now being seriously questioned. This point is vividly illustrated in Figures 4 and 5 below.

Figure 5: Swiss Banks' Profits

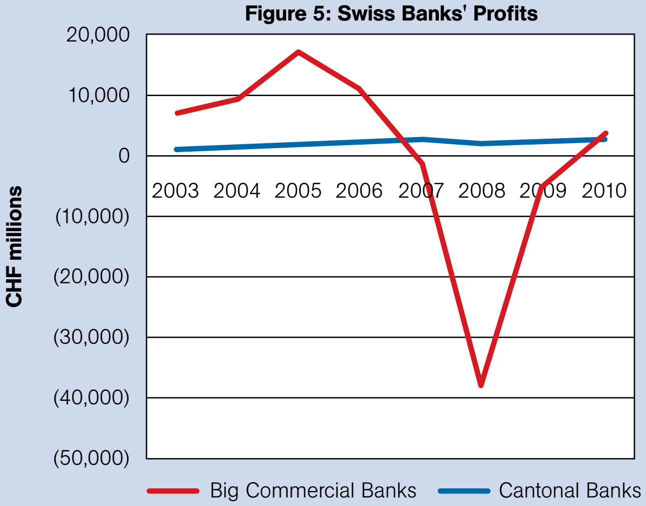


Figure 5: German Banks' Return on Capita

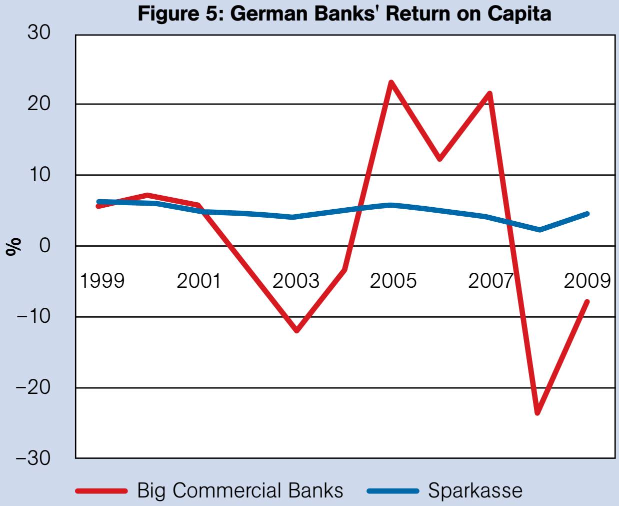


Figure 4 shows that Swiss government savings banks, called Cantonal banks, achieve low but stable profits in comparison to commercial banks. In fact, not only did Cantonals achieve higher average profits between 2003 and 2010 (CHF 2,113 million vs. CHF 441 million), commercial banks' profits also had a standard deviation nearly 340 times higher than that for Cantonals. A similar result can be seen in Germany (see Figure 5), where German publicly owned savings banks, called Sparkassen, achieved both a higher average return on capital between 1999 and 2009 than commercial banks (4.7% vs. 2.2%), and a standard deviation nearly 13 times lower.

It is argued that politicians may interfere in the commercial operations of the BBB to direct credit towards projects that benefit them politically, even if they do not necessarily produce wider social or economic benefits for the rest of the country. This crucial issue will be discussed in more detail in Chapter 6.

No matter how a local banking infrastructure is rebuilt, it will take time to establish the necessary skills, local knowledge and ability to assess loan applications without crude credit scoring techniques. A local banking network does not absolve investors in innovation from the need to fully understand markets and technologies.

These three options for building local banking distribution networks – community finance sector, local challenger banks, and restructuring RBS – are not mutually exclusive. However, breaking up RBS would certainly have significant time advantages over growing the sector from scratch, so we are planning further research on this proposition.

If restructuring RBS proves impossible, the least risky alternative would be for the BBB to develop its own network of branches. At this stage it is difficult to say how many branches or how much capital investment would be needed. A key question is at what size does a branch network begin to lose the advantages of localism, including intimate knowledge of the local area. Comparison with Japan (153 branches) and Canada (106 branches) indicates that the smaller and more densely populated UK might need between only 50 and 100 branches to achieve equally effective coverage. This would not replace the day-to-day banking services of the commercial banks, and could operate more like the SBA before 1996 – a lender of last resort as well as a source of mezzanine and equity finance.

Under this (and indeed the RBS option) the BBB could make referral arrangements with other banks, who would continue to meet most of their clients' banking needs. It could also make referral arrangements with accountants and other professional services. This would limit the number of branches required. In practice, we expect that the BBB would start with relatively few branches and expand as the volume of business expanded.

A variation on this option would be for the BBB to acquire a branch network, perhaps carved out of RBS, but in practice the associated costs are likely to make this unattractive. No suitable branch network covering the major population centres across the UK is available. And splitting the RBS network along these lines would be unlikely to make commercial sense for the remaining branches, as the profitable branches would probably be cherry-picked for the BBB.

We summarise the distribution options in Table 8 below.

Table 8: Distribution options for the BBB

Option	Advantages	Disadvantages
DIRECT DISTRIBUTION		
1 Establish branch network (50-100 branches)	• No legacy issues • Branch network, systems and staff built to fit the specific purpose of the BBB	• Cost of investment • High operation risk associated with any start-up • Operational losses during start-up phase may be considerable • Would take many years to reach scale
2 Acquire branch network (50-100 branches)	• Speed • Greater certainty of acquiring existing operational branches, systems and staff	• Cost of investment in branch network • No suitable set of branches available • Carving up RBS would potentially severely reduce value of remaining network • Potential legacy IT, systems and cultural issues
INDIRECT DISTRIBUTION		
3 Rely on existing banks	• No cost or delay	• Risk that BBB fails to be effective due to lack of local banking infrastructure
4 Scale up existing community finance sector (credit unions, CDFI, building societies)	• Sector exists and is growing • In line with existing policy	• Mostly focused on personal banking • Would take years or decades to reach scale
5 Create new form of banking licence to specifically encourage local bank start-ups	• In line with existing policy to encourage competition	• Would not achieve nationwide coverage • Some areas might not be sufficiently attractive to profit-maximising banks
6 Restructure RBS into network of locally autonomous banks similar to Sparkassen system	• Nationwide coverage • Only option that can created local bank network at scale and speed	• Requires sophisticated calculation of trade-off between long-term value creation for British economy and short-term Government revenue from privatisation • Implementation risk of restructuring

6. Other issues

This chapter covers corporate governance at national and regional level, co-ordination with other regional agencies, compliance with EU State Aid rules and national accounting rules.

6.1 Lessons from overseas institutions on corporate governance and recommendations for national governance

Governance arrangements are particularly important in a public bank, to ensure that the mandate is properly pursued, and that private financial and political interests are not served. We have reviewed the governance arrangements in international, national, regional and local banks overseas, and looked at examples of failure to draw some broad lessons.

First, a clear division between a supervisory and a management board is almost universal practice. The former can and should contain political representation (as part of the chain of democratic accountability). The latter should contain banking professionals and perhaps a few business non-executives. This division was not maintained in the case of the 'cajas' (Spanish savings banks) with disastrous results (see Box 21).

Second, there is a strong case for the supervisory board to contain representatives of the opposition as well as the government party. Giving the opposition the chance to test and question the bank's strategy from the inside helps keep the management on mission, and prevent collusion between government representatives and management to depart from the mandate. This at least is the view of the representatives of the Sparkassen in Germany, who contrast their experience with that of the Landesbanken (see Box 22). This kind of representation could also make the bank less of a political football.

Third, several banks have staff representatives on the supervisory board. Others have representatives of trade associations, partner banks or other stakeholders (see Boxes 23-25). Others have entirely public membership. Our initial view is that the board should *not* have representatives of business interests but that these should be represented on an advisory board.

Fourth, for the most part the banks are formally banks, and so subject to banking regulation. They have to be run on commercial grounds (although this does not preclude their having a broader economic mandate) and their financial results are publically available and audited. German public banks are audited by federal and state courts of auditors. Public banks that deploy EU funds must also report to the European Court of Auditors.

Fifth, while supranational banks inevitably have a more formal governance structure than would be appropriate for the British Business Bank (in some cases a three-tier board), they do illustrate the way representation of different territories on a board can work. In the British case, this would be different regions. The Nordic Investment Bank operates on a principle of one country, one vote. This is preferable if one wants to ensure that a bank serves all regions equally. It also has a rotating chairmanship. Could the BBB's board be dominated by regions in this way, with a rotating regional chair? Or do central government ministers have to dominate?

Of course the UK does not have elected representatives for its different regions. But if regional boards are set up (as we suggest earlier in this paper), they could elect representatives to sit on the BBB's supervisory board, and instruct them on how to vote.

So our recommendations for national level governance are:

- government should be the sole shareholder of the bank, but should exercise its control through a Board of Governors
- this Board of Governors would appoint and set targets for a separate management board, based on the performance indicators we have identified, which would be entrenched in the bank's constitution (the 'Board of Governors' is what we have simply referred to as the 'board' earlier in this report)
- there should be constraints on the Board of Governors' powers to instruct management
- the Board of Governors' members should include representatives of regional boards, ministers, and opposition politicians, and there should be at least one staff representative, preferably with trade union backing. The Chair does not need to be a minister or a ministerial appointee
- our initial view is that representatives of business, the trade union movement and academia should join an advisory board rather than the board itself
- Parliament should also set up a select committee with powers to question the bank's governors and management and to make recommendations (in line with the IPPR's idea for a special board with this function).

6.2 Governance and collaboration with other agencies at regional level

As already stated, the BBB cannot achieve its objectives in isolation. It will work with other agencies that have similar mandates to deliver good, sustainable jobs in all parts of the country. This will be a complex process so we have attempted to summarise its key elements, using the North East as an example, in Figure 6. Collaboration will involve business and interventions by central and local government, and associated agencies – of which the BBB is one. It will also involve strategy and planning to guide these interventions. We are not making recommendations for the design of other institutions; we take existing structures as more or less given. However, in the figure we have used the institutional architecture proposed in the recent North East Independent Economic Review,[107] and referred to the various bodies it proposes.

The colour coding in Figure 6 distinguishes three aspects of this process.

The blue boxes are business activity. Good jobs, that are facilitated by the BBB, will be delivered by business activity, so all the arrows lead to these boxes.

The red boxes are the influences government has on business activity, including regulation, support, and the prospect of support. This includes the BBB, which provides finance to business.* All the red boxes refer to activities that already take place in some shape or form.

The green boxes are the ways regulation and business support are guided and planned, including the government's economic policy objectives, performance targets and industrial strategies. They include short-term performance targets, industrial strategies and the longer-term targets based on them. These activities will help the BBB and other agencies work together effectively.

This structure has implications for the regional governance of the BBB and the role of its regional offices. But before we examine these, let us look at issues arising from the figure.

First, does industrial strategy have to be developed at a regional as well as national level?

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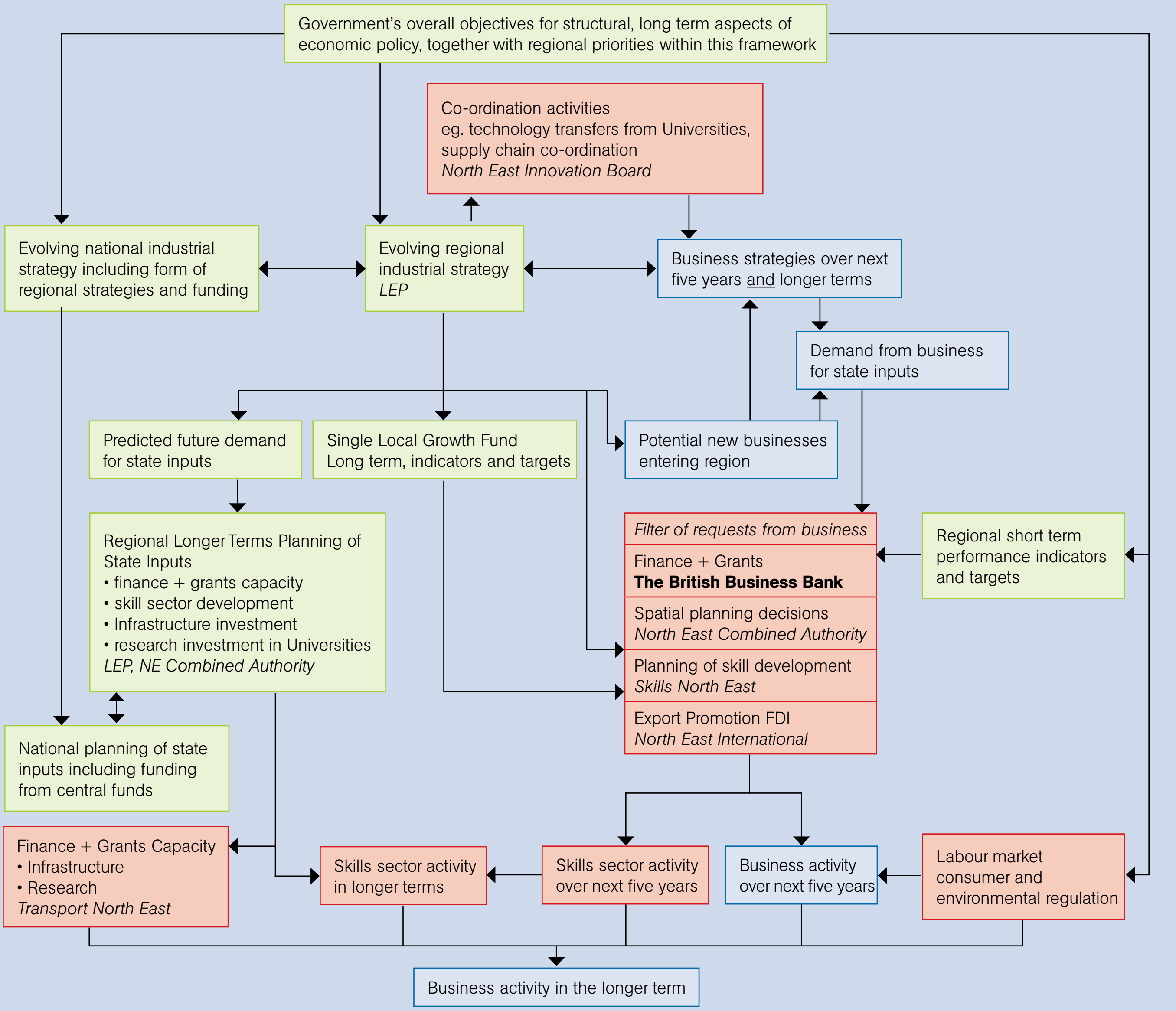
* While we are taking much of the structure as a given and will argue that a single agency – a kind of super RDA – is not appropriate, and while there is sometimes merit in competition, there is no merit in a proliferation of agencies. So in the case of the North East, we recommend that the BBB is responsible for all financing activities under the North East Finance and Investment Board.

Figure 6: The BBB's place in the North East's business support system



Yes. Businesses exist in particular places, as do the universities which provide them with research; the land on which they build; the people who work for them; the colleges which train the people who work for them; the roads and railways that transport their goods; and the other businesses in their supply chains. Of course certain decisions need to be taken centrally, for example, to reduce unproductive competition between regions, or co-ordinate sectors that spread across regions. Decisions about regions can also be taken centrally and sometimes are. However, there are many decisions that are better made by those with local knowledge. This is the thrust of the Heseltine report, *No Stone Unturned in Pursuit of Growth* and now largely accepted as policy.[108]

Second, with this in mind, is the kind of multi-agency structure outlined above really efficient? Shouldn't everything be folded into local authorities? Or shouldn't we create a set of regional super RDAs, rolling into them investment banking, planning and skills functions?

No. For one thing, separate agencies already exist (or are being developed) to handle various parts of the system. Why change things if there is no need to? More importantly, different parts of the system are likely to need different culture and governance. International experience suggests local authorities should not control banks. Equally, we would argue, the LEPs should not control the BBB. While bankers need to know and understand their clients, a certain distance is required, particularly when public money is involved. LEPs, by contrast, need to be close to the business community. Skills planning, for example, might benefit from greater input into decisions from businesses themselves. Regional industrial strategy may need to be 'owned' by business, trade unions and local authorities. So LEPs and the BBB will work closely together but need to be separately accountable, creating a little transparent tension in the system. Rolling everything into one would create an unwieldy, and above all dangerously unaccountable institution – a criticism sometimes made of the RDAs.

Of course if LEPs are responsible for an industrial strategy designed to achieve good, sustainable jobs, they will need investment in their capabilities and a legitimacy they do not all currently have. They might, for example, become genuine three-way partnerships between local authorities, local business and local trade unions. Some LEPs may merge.

However, if the LEP is responsible for regional industrial strategy but separate from the BBB, does it effectively generate the BBB's long-term regional targets that should be based on that strategy? Do we end up with the LEP board directing the BBB's regional board, making the latter largely redundant at least when it comes to strategy?

Again the answer is no. More detailed work is needed on the terms of reference of LEPs and their boards, and the BBB's regional offices and their boards. But we propose the following points for discussion.

- LEPs should be responsible for drafting regional industrial strategy, drawing on input from BBB staff as described in Section 4.3. The draft will be approved by the LEP board.
- The BBB regional board will then translate this into targets using the performance indicator framework agreed for the BBB, as described in Chapter 3.
- In the event that the two boards disagree about these targets, the matter will have to be resolved by BIS.

If we assume that LEP boards include representatives of local authorities, trade unions and regionally based business, the BBB's boards could comprise:

- representatives of the regional LEPs
- representatives of MPs from the region – from government and opposition parties
- a representative of head office
- a staff representative (preferably with the backing of a trade union)
- representatives of banking and venture capital in the region
- representatives of other agencies implementing industrial policy (e.g. potentially agencies responsible for innovation, skills development, infrastructure)
- 'pure' non-executives co-opted by the other members.

6.3 Compliance with the EU state aid rules

The operations of the BBB must not contravene the EU State Aid rules (see Box 27). This might happen in two very different ways. First, the BBB – or local banks through which it distributes its products – might appear to be receiving state aid because of implicit or explicit government guarantees and lower interest rates it enjoys as a result of them. Second, the investee companies might appear to be receiving state aid if they access funds on more favourable terms than those available to other companies.

On the first question, commercial banks have, unsurprisingly, been very vocal. They extensively lobby governments and the EU, although their case has become somewhat weaker since the bailouts (see Box 28). There are two ways round this problem for the BBB. One is for it to pay the government for any additional level of guarantee it receives. Some public banks do this. Over 50 per cent of Swiss Cantonal banks pay a fee to compensate for the backing of their regional government.[111]

Box 21: Cajas – the need to keep politicians away from operations

Spanish savings banks, called ‘cajas’, are private institutions but own themselves and don’t issue shares. Many of these banks have failed in recent years, largely as a result of the property bubble bursting, and the failure and nationalisation of Bankia (a restructured bank based on seven failing savings banks).* The tipping point that prompted the Spanish government to request an EU bailout was in 2012.[109] In 2010 there were 45 cajas, now there are only ten.

According to the organisations we interviewed, there were two key reasons behind the cajas’ troubles.

1. There was too much political interference. Politicians wanted to develop real estate in their own regions and encourage savings banks into real-estate markets. As a result, cajas became heavily involved with financing residential and commercial construction projects, as well as mortgages. Local governments did not own the savings banks, but until 2010 they sometimes made up to 50% of the board of directors. Boards were responsible for day-to-day operations. (Other members of the board would typically include representatives from staff, depositors, and the caja’s founders. In 2010 a 50% cap of local government representation was tightened to 40%).

   It is highly unusual that local or regional governments should have representation on the board of a savings bank that oversees the bank’s day-to-day operations. Such influence is typically restricted to the supervisory board, which is only responsible for approving the overall strategy of the bank.

2. Cajas moved away from their traditional roles bit by bit. First, they had their regional restrictions lifted in 1989. Before this, the banks were restricted to doing business within their local area. When the financial crisis struck, cajas frequently suffered high default rates on loans issued outside of their historic market. The Association of German savings banks (DSGV) contrasted this with Germany, where local banks only operate in markets they really understand.

   In addition, cajas funded expansion over the last 20 years by tapping the short-term wholesale market rather than relying on savings. This unravelled during the credit crunch when the inter-bank lending markets dried up. This, combined with the collapse in the value of their property assets, pushed the cajas to the brink and over.

   Finally, the cajas had never developed the central and regional institutions that savings banks in, for example, Germany have. This meant there was no peer-control and supervision. In contrast, the German Sparkassen operate a joint-liability scheme, and so have a strong incentive to monitor one another.

The lesson from the cajas story for the BBB is relatively clear: local government may need to be represented on the supervisory board at regional level to help ensure the overall strategy is in keeping with local interests. But politicians should not hold positions on the board responsible for the day-to-day operations. This is not just something that happens at local level. In the early 2000s, the Canadian Prime Minister interfered with one of the BDC’s credit decisions which threw the bank into political crisis. Regulations have since been tightened, so that staff have to flag any potential political interference. Non-interference with the BDC was also added to the code of conduct for Canadian cabinet members.

* In a bid to prop up the sector, seven savings banks were merged in 2010 to form a new entity called Bankia, which, just half a year later, was floated as a public company to shore up its capital position. Such mergers were seen as the best way to bring strength and stability to the system. Unfortunately they only delayed the inevitable. Bankia turned to the government for a EUR 19 billion bailout in May 2012. The network of Bankia branches had also been used to promote Bankia shares to ordinary savers, who subsequently all suffered enormous losses on their investments.

Box 22: Landesbanken: the need for checks and balances

The German Landesbanken are the regional institutions established by Sparkassen to provide liquidity management services for the network and to enable small, local banks to achieve economies of scale. However from the 1970s until the onset of the recent financial crisis, many policy makers and financial commentators began to view them as inefficient institutions that couldn’t match the 20% returns on equity posted by commercial banks.

Landesbanken’s supervisory boards are typically composed of representatives from Sparkassen, regional government (that is, ruling party politicians) and other stakeholders, such as industry groups. This did not restrain the management. Indeed Landesbanken were actually put under pressure by local politicians and financial commentators to boost their returns to match commercial banks.

As a result, they became bigger, had a greater international focus, and started to invest in complicated, high-yielding financial products, such as mortgage-backed derivatives, which later turned out to be enormously over-valued. In the end, many were bailed out jointly by Sparkassen and the federal government.

The Deutscher Sparkassen und Giroverband (DSGV) – the trade organisation for the Sparkassen – maintains that a crucial difference in the Sparkassen and Landesbanken corporate governance models is that representatives from the regional *parliament* (that is, ruling and opposition parties) sit on Sparkassen boards, whereas representatives from regional *government* sit on Landesbanken boards. This difference, so it is argued, introduces crucial checks and balances for Sparkassen. The multi-party influence in effect introduces an element of conservatism (with a small c).

But the Sparkassen are not perfect either. In 2009 Sparkasse Koln-Bonn invested in an extremely large infrastructure project that turned out to not be worth as much as originally thought. This prompted extensive public discussion and it was often argued that local government had put pressure on the bank to invest.

The lesson for the BBB from the Landesbanken story is interesting because it involved a tacit collusion between management and regional governments, as they both got caught up in the pre-crash *zeitgeist*. It is reasonable to argue that if opposition politicians had been on the board – in a position to question the strategy from the inside – there would have been more caution and less mission creep.

During the financial crisis, similar problems occurred with some (but certainly not all) of the central institutions founded by public and co-operative banks in a variety of countries. For example, the troubles encountered by Rabobank's central institution in the Netherlands.

Box 23: Corporate governance structures of a sample of national investment banks

Name and country	Membership of highest level board	Other aspects of the structure
Business Development Bank of Canada (BDC) Canada	The 12 members of the non-executive Board of Directors are appointed by the Minister of Industry in accordance to a set of defined criteria. Bankers, accountants and entrepreneurs are typically appointed. There are no government representatives.	Every year the bank submits a five year plan to the government for approval. The Board of Directors sets the overall strategy for the organisation. Day-to-day operational decisions are taken by the management team. There are also various committees, such as the Credit and Risk Committee, which approves loans and monitors credit risk, and the Venture Capital Investment Committee, which approves venture capital investments.
Brazilian Development Bank (BNDES) Brazil	The director and the president of the bank are nominated by the President of Brazil.	The directors meet once a week to take operational decisions. All their decisions go through internal technical committees, such as the Credit Committee, which is responsible for making all the bank's lending decisions. The directors can veto technical committees' decisions, but they can't force the committees to undertake or approve a given action. The directors can appoint staff to senior positions, but they can't appoint individuals external to the firm to senior positions.
Kreditanstalt für Wiederaufbau (KfW) Germany	Representatives from the Ministry of Finance and the Ministry of Economy take turns annually to head up the Supervisory Board. There are 37 members of the Supervisory Board in total, which is composed of representatives from the Ministry of Development Finance, the Ministry of Housing and Construction, the German states, trade unions, business associations, and members of Parliament.	The Supervisory Board approves the overall strategy of the organisation and the different product lines. However, it is not allowed to interfere with the day-to-day running of the bank. KfW, unlike the German regional banks and the Sparkassen, is not technically a bank.
Russian Bank for Small and Medium Enterprises Support Russia	There are nine members including representatives from Vnesheconombank (the state owned bank that owns the SME bank), the Ministry of Economy, and industry associations, e.g. Chamber of Commerce and Small Business Association. (N.B. the Supervisory Board of Vnesheconombank is composed of representatives from relevant government ministries).	The Supervisory Board decides on product concepts and the overall direction of the institution. The decisions taken by the SME bank Supervisory Board then have to be discussed with the Russian government. Lending decisions are approved by a Credit Committee, which is composed of financial services professionals.

Box 24: Corporate governance structures of a sample of German regional state banks

Name	Membership of highest level board	Other aspects of the structure
LFA Bavaria	Representatives from its on-lending partner banks, i.e. Sparkassen, in addition to representatives from regional government. The representatives from partner banks change every two years.	Sometimes the bank will pitch an idea to regional government, and sometimes that government will give the bank money for a specific programme, or instruct it to find a way to put a specific policy objective into operation.
NRW.Bank North Rhine-Westphalia	Representatives from regional ministries, including the Ministry of Finance and the Ministry of Economic Development. Representatives from the workforce also sit on the Supervisory Board.	Regional government ministers set the overriding policy objectives that the bank's programmes must expedite. The bank undertakes an analysis phase and discusses the policy objectives with the ministries to determine what measures should be taken. Banking expertise is deployed at the product development stage. The main factor regulating the bank's work and protecting it from ministerial interference is that it has to abide by German banking regulation and standards.

Box 25: Corporate governance structures of a sample of government savings banks

Name and country	Membership of highest level board	Other aspects of the structure
Cajas Spain	There is currently draft legislation that, if passed, will change this. Cajas will become foundations with a social purpose which own or part own profit maximising commercial banks. The boards of the foundations will be able to contain only up to 25% public representatives. The bank boards will be entirely composed of financial services experts. Politicians, trade unionists, and representatives from public administrations or professional associations will not be allowed.	The foundation could use the dividends it receives from the commercial bank to invest in community development, local economic development, etc. The commercial banks will be able to raise capital on the capital markets No more than 25% of the attendees at the bank's (not the foundation's) AGM must represent public bodies.
Cantonal Banks Switzerland	Precise structures vary from state to state. The board of directors will be composed of a variety of the bank's stakeholders, including local government representatives.	The Board of Directors is responsible for ensuring that the bank's overall strategy 'as far as possible, reflects the different tendencies of the Canton's economic and social life.' [110] There is generally an executive board, composed of financial services professionals, responsible for the day-to-day running of the bank.
Norwegian Savings Banks Norway	Representatives from local authorities, depositors, staff and equity certificate holders.	The larger Norwegian savings banks allow a limited amount of private investment in the bank; however, the shares issued come with limited voting rights.
Sparkassen Germany	The composition of the board of administration varies from state to state. However, roughly one third of the board will typically be composed of staff representatives, and the remaining two thirds will be representatives from local government. These representatives are appointed by the local parliament, not the local government, so there will be representatives from all parties that won seats in the region.	The board of administration is responsible for setting the overall strategy of the bank. This board also has the power to suggest (subject to regulatory approval) people for senior management positions, and to fire managers if necessary The management board is responsible for overseeing the day-to-day operations of the bank, and is composed of at least two people, who all must have financial accreditation, i.e. a license from the German financial regulator. However, there is no formal restriction on management board members having a link to local government. There are regional supervisors that monitor the activities of the Sparkassen, to ensure that they are abiding by business principles to meet their social mission, and that they aren't facilitating pork-barrel projects.

Box 26: Corporate governance structures of a sample of supranational investment banks

Name	Corporate governance structure
Asian Development Bank	Each member country has a representative on the Board of Governors. The latter elects a Board of Directors from among themselves, and the bank's president, who chairs the Board of Directors. As Japan has put the most equity into the bank, the president is traditionally Japanese. Eight of the 12 member states from the Asia-Pacific region will be elected to have one representative each on the Board of Directors. The remaining four seats will be composed of representatives from non-Asia-Pacific region member countries, such as the US and European countries.
Council of Europe Development Bank	There is a Governing Board, which decides on the strategic orientation of the bank, and is composed of representatives from the foreign ministries of the member countries – typically ambassadors to the Council of Europe. Voting rights are split in proportion to countries' ownership stakes in the bank. The Administrative Council oversees the day-to-day running of the bank. It is composed of representatives from the ministries of finance from the 40 member countries. Countries that have put more equity into the bank have a proportionately larger share of the votes. All lending decisions have to be approved by the Administrative Council, but new product lines must be approved by the Governing Board.
European Investment Bank (EIB)	The finance ministers from the 27 EU member states sit on the Board of Governors. It sets the overall strategy for the bank, including for its operations outside of Europe, and elects the Board of Directors. The latter is responsible for approving loans and guarantees. Each member state will elect a representative to the Board of Directors, and the European Commission elects the 28th member. Countries have voting rights in proportion to the amount of capital they have injected into the bank. However, for a motion to pass, it must be approved by one third of the member states and the majority of the shareholders in terms of ownership. The Board of Directors may invite six people with relevant professional experience to sit in and advise in meetings but these individuals do not have voting rights. The Board of Directors appoints the nine members of the Management Board, which is responsible for overseeing the day-to-day operations of the bank. The four largest shareholders – France, Germany, Italy and the UK – have a permanent seat on the Management Board.
Nordic Investment Bank	The Ministry of Finance from each of the eight member countries has one vote on both the Board of Governors, which is responsible for setting the overall strategy of the bank and the Board of Directors, which takes operational decisions. Chairmanship of both boards rotates according to a pre-defined schedule.

However, regional, national and supranational promotional banks generally take a different approach. They show that what they do complements rather than competes with commercial banks, so the guarantee does not "distort or have the potential to distort competition – i.e. strengthen the beneficiary relative to competitors". This means the guarantee does not count as state aid (see Box 27). The bank would need to provide evidence that it does not take business away from commercial banks. There are two ways it could do this.

First, if it uses other banks to distribute its products, it would need to make its funds available to all banks (which is what KfW does – see Box 29) on the same financial terms as other wholesale providers. (The extra margin it enjoys would be used to pay for the additional operating costs associated with its mandate and any specific 'soft' loan or investment schemes). Second, if it lends directly, it would need to show that it was not taking business from existing banks. One way to do this would be to set up a referral scheme (as mentioned in Chapter 5) so that the BBB only takes on the more difficult cases that existing banks do not wish to serve.

On the second question (aid to investee companies), a different approach would be needed. Providing finance on more favourable terms than the market will often count as state aid. However exemptions can be used, in particular:

- the *de minimis* exemption (€200,000 of aid, as opposed to financing, over three years)
- the General Block Exemption Regulation, which permits certain kinds of aid (regional, SME, aid promoting entrepreneurship, aid to disadvantaged and disabled workers, aid for environmental protection, risk capital aid, training and employment aid, and aid for research, development and innovation)
- and various other temporary exemptions the UK government has negotiated.

In short, the State Aid rules are not an insurmountable barrier to the proposals in this report, but will need to be navigated carefully.

6.4 The BBB and National Accounting Rules

Summary of key points

Under the approach used to measure the performance of public sector finances in the UK (which is in place for historical reasons which are now redundant), it is likely that the introduction of a BBB would lead to a sharp deterioration in the appearance of public sector finances.

This deterioration is misleading as the assets and liabilities of the BBB are qualitatively different to general government assets and liabilities. The institution would be largely self-financing and the government would only be liable for initial capital injections and losses that the capital base cannot absorb – not its entire balance sheet.

The impact on the appearance of public finances could result in unnecessary restrictions being placed on the BBB's ability to raise funds in capital markets.

If the UK were to adopt fiscal targets based on the internationally recognised measures of general government debt used by most EU and OECD countries, the BBB's impact on the appearance of public sector finances would be small. This approach is more appropriate.

So there are two possible solutions:

- change the fiscal target to the internationally recognised measure of general government debt
- make special provision for the BBB in the way the UK calculates public sector net debt, by allowing a wider range of BBB assets to be netted off against the its liabilities.

Box 27: EU State Aid rules

EU State Aid rules aim to ensure fair competition and a single common market. Giving favoured treatment to some businesses would:

- harm their business competitors and risk distorting the normal competitive market
- hinder the long-term competitiveness of the community by propping up inefficient, aid dependent companies
- allow those member states with the deepest pockets to favour their own industries.

Support has to pass four tests for it to count as state aid.

1 It has to be granted by the state or through state resources

2 It has to confer a selective advantage to an undertaking – i.e. some undertakings get it and some do not

3 It has to distort or have the potential to distort competition – i.e. strengthen the beneficiary relative to competitors

4 It has to affect trade between member states – in practice affect any market where the goods or services are tradable between member states.[112]

Box 28: Government support for commercial banks

In the aftermath of the financial crisis, investors now assume that host governments will step-in and bail out large, highly interconnected 'too-big-to-fail' (TBTF) institutions if they get into trouble. Lending money to a TBTF bank is therefore considered less risky than it would be without this implicit government backing. This translates into lower interest rates, which save banks enormous sums of money when they borrow. These savings are called the 'TBTF subsidy', and many commercial banks have benefitted to an extraordinary degree from such subsidies. For example, the four largest British commercial banks enjoyed a combined £45 billion TBTF subsidy in 2010.[113] None of these institutions would even have broken even in 2010 without this subsidy. So commercial banks are no longer in such a strong position to lobby against state backing of public banks.

Box 29: How a sample of public banks, in and beyond the EU, demonstrate they are not distorting the market

Name	Regions covered	How additionality is demonstrated
Business Development Bank of Canada (BDC)	Canada	Filing four market gaps: 1. the market not financing risky ventures, even with loans at high interest rates 2. the market not providing very small loans, due to relatively more expensive administrative costs 3. the market not providing loans with flexible repayment terms 4. the market's low appetite for financing 'knowledge-based industries', due to such enterprises not having tangible assets, and loan officers having a lack of relevant expertise. It sometimes works with financial institutions (for example, on-lending for rural communities) and provided support to the Canadian financial system during the financial crisis. It is not allowed to take deposits, as this would inherently involve competition with commercial banks.
Brazilian Development Bank (BNDES)	Brazil	With on-lending projects they are lending to commercial banks, not competing with them. They do not pick winners: any project that fits the criteria will receive funds. They do not solicit requests from companies; they receive applications.
Council of Europe Development Bank		Most of the bank's lending is through bank and non-bank intermediaries, such as leasing companies.
Kreditanstalt für Wiederaufbau (KfW)	Germany	It works with banks as it does on-lending. So, it cannot be said to be crowding out market activity.
Nordic Investment Bank		The bank only lends through other banks.
NRW.Bank		It does not compete for deposits or lend directly to SMEs; it lends through other banks. It does not discriminate against any type of bank. It has to mobilise private capital with its equity injections.
Russian Bank for Small and Medium Enterprises Support	Russia	It lends through banks and leasing companies.
Small Business Administration (SBA)	US	Its guarantees are aimed at businesses that wouldn't normally qualify for bank financing.

There is a third solution - removing the BBB from public sector net debt like the Bank of England - but this is unlikely to find favour.

Recent changes to the fiscal target suggest that there is some flexibility in this matter if there is appetite for change. (A new measure was recently introduced to exclude temporary financial interventions, and changes were made to allow short-term quantitative easing profits to reduce the deficit.)

More detail

In 2010 the Coalition Government set out to eliminate the structural deficit by the end of this parliament. When it set up the Green Investment Bank, the Coalition decided it would only get full borrowing power when public sector net debt was falling as a percentage of GDP. The BBB may be treated in a similar way in national accounting statistics, and this will impact on its ability to raise funds on capital markets.

For the purposes of measuring the fiscal position, most members of the European Union and OECD use general government debt.[114] Generally, this measure includes the liabilities of central government, local/regional government and social security funds, but excludes public corporations which undertake market activities or financial intermediation.[115] The debt and deficit limits required under the Maastricht Treaty are defined in terms of general government debt.[116]

The UK, however, chooses to use a different measure,[117] which includes a majority of the financial liabilities issued by public sector institutions (including corporations) but subtracts public sector holdings of liquid financial assets, such as bank deposits.[118] Dolphin and Nash (2012) suggest the reason why the UK uses this measure is because borrowing by public sector enterprises – such as the railways and Post Office – used to mostly take place through the government bond market.[119]

The choice of measurement approach would not make a substantive difference to how the BBB affects government debt levels or government borrowing requirements. But its impact on the appearance of public sector finances could change significantly according to the approach chosen.

As a largely self-financing public institution carrying out financial intermediation, the BBB's assets and liabilities would be excluded from the general government debt statistics adopted by most countries. The only impact the BBB is likely to have on general government debt measures would be the initial capital injection required to start it up (which presumably would come from central government) and any further capital injections if they were required.

Under the measures favoured in the UK however, the BBB would lead to a large increase in the reported levels of public sector net debt. This is because most of the BBB's liabilities would be included in the measure, but only a small portion of its assets would be netted off. (This is because most of the BBB's assets would be non-liquid investments in businesses).

The UK's public sector net debt approach might well distort the true picture of the BBB's impact on the state of public finances. As noted by Dolphin and Nash (2012), there is a qualitative difference between general government borrowing because spending exceeds tax revenues, and borrowing by a financial intermediary to invest in assets which are likely to generate (profitable) returns. Many other national investment banks are profitable, with the Business Development Bank of Canada having paid $180mn in dividend payments to the Government of Canada since 1997. Even if the BBB made persistent losses, the government would only be liable for losses made, likely to be only a small fraction of the amount by which the BBB would increase public sector net debt under the UK accounting approach.

It would be sensible for the UK to measure the performance of public finances using the general government borrowing measures adopted by the majority of its peers. The UK's current accounting approaches are primarily in place for historic reasons and could very well restrict the BBB's ability to borrow.

If converting the UK fiscal system to an internationally recognised standard for government debt is not possible in the short term, it would be sensible to consider making special provision for the BBB within the UK framework for measuring public sector net debt.

One option would be to allow a wider array of BBB assets to be netted off against its financial liabilities – which would reduce its impact on net public sector debt. Another would be to exclude BBB assets and liabilities from the public sector net debt statistics, in the same way that the Bank of England's assets and liabilities are excluded, although this is unlikely to find favour.

Some argue that it would not be possible or appropriate for the UK to make special provision for the BBB. But since the onset of the financial crisis, the UK government has made changes to the headline measure of public sector borrowing. This demonstrates there is some flexibility.

During the financial crisis, it was realised that the emergency stabilisation measures put in place (nationalising banks, liquidity support) would affect the traditional measure of public sector net debt/public sector net borrowing. The solution found by national statisticians was simple: temporary financial operations were stripped out, so that fiscal targets were based around 'public sector net borrowing excluding financial interventions' or 'PSNBex'. The rationale was to try to "show the underlying state of the public sector finances without temporary distortions caused by financial interventions, but including any permanent effects from these interventions".

In February 2012, it was announced that profits from the Bank of England's Quantitative Easing (QE) Programme would be transferred to HM Treasury and that this would have the immediate effect of reducing the public sector net borrowing requirement.[120] This decision was made even though the intra-government transfer would make no substantive difference to the state of public finances and it was (and is still) unknown whether the overall QE programme was likely to make a profit or a loss. (It is currently making a profit, but is likely to make losses as asset purchases unwind and *ex-ante* it is impossible to know whether the initial profits will exceed the losses). [121] Many commentators were critical of the decision.[122]

The introduction of the PSNBex and the subsequent change in the treatment of QE profits demonstrate that there is flexibility in the way the performance of management of public finances is assessed. The introduction of the PSNBex was not required under international accounting principles. The technical change to allow short profits of QE to reduce PSNBex ran counter to the principle on which PSNBex was established. (This was to exclude temporary but include permanent effects of financial interventions.) It was not required under international accounting principles either.[123]

Appendix

List of organisations interviewed

- Brazilian Development Bank (BNDES)
- Bundesverband Öffentlicher Banken Deutschlands (VÖB) – The Association of German Public Banks
- Business Development Bank of Canada (BDC)
- Confederación Española de Cajas de Ahorros (*CECA*) – Confederation of Spanish Savings Banks
- Council of Europe Development Bank
- Deutscher Sparkassen und Giroverband (DSGV) – The German Savings Banks Association
- European Investment Bank (EIB)
- European Savings Banks Group
- Kreditanstalt für Wiederaufbau (KfW)
- LFA Bavaria
- Nordic Investment Bank (NIB)
- NRW.Bank
- Russian Bank for Small and Medium Enterprises Support
- Small Business Administration (SBA)
- Sparebankforeningen – Norwegian Savings Banks Association
- Verband Deutscher Bürgschaftsbanken (VDB) – The Association of German Guarantee Banks

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