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Dear Gordon,

Scottish National Investment Bank Bill – Financial Memorandum and Stage 2 matters arising

In my letter of 7 November 2019 I undertook to update the Committee on the further financial modelling then being conducted to better establish an indicative profile of returns to the Bank on a prospective investment portfolio. I am pleased to be able to provide that update now. I have set out some of the key results below and further detail is provided in Annex A.

The latest financial modelling updates the information set out in the Financial Memorandum published in February 2019 and reflects subsequent progress made in operational planning for the Bank. In particular it takes into account an anticipated profile of returns on investments which will transfer into the Bank once established, including the precursor Building Scotland Fund. Establishing an anticipated profile of returns is of particular importance to projections of the Bank's performance in the early years, especially given the Bank's focus on patient capital. It also enables us to project when the Bank will be able to meet the expectation that it is able to recycle and reinvest its funds, growing its asset base, and to cover its own operating costs, and not be reliant on revenue support from the Scottish Government.

In addition to the financial modelling there are also a number of matters which arose during Stage 2 of the Scottish National Investment Bank Bill which I would like to offer the Committee further clarity on. I have set these out at Annex B. I hope this is helpful and I look forward to engaging further with the Committee on these issues.

Finally, for the Committee's information, I have also taken this opportunity to provide below an update on the ongoing close collaboration between the Scottish Government and Scottish Enterprise to support the transition process once the Bank has been established. This includes how an initial period of transition will be managed in the first years of the Bank in order to deliver a smooth and effective transition of relevant business from Scottish Enterprise and to ensure effective future coordination and cooperation.

Financial modelling and financial projections

A financial model for the Bank was initially developed between November 2018 and January 2019, informing the Financial Memorandum published alongside the Bill when it was introduced in February 2019. Since then, the financial model has continued to evolve, informed by ongoing operational planning for the establishment of the Bank and the development of an anticipated profile of returns on pre-cursor investments and on forecast investments based on indicative investment profiles. These are a mixture of debt and equity product profiles and which vary by a number of elements including: investment term; repayment profile; interest or dividend rates; and failure and recovery rates.

The financial modelling identifies a prospective profile of returns to the Bank over a 50 year period. This is intended to provide indicative projections for the income of the Bank in the long term. Income received by the Bank, as part of supporting sustainable and inclusive economic growth, will fulfil a number of purposes across that 50 years period: it will be recycled and reinvested as the Bank grows its asset base; it will also support the longer-term repayment of Financial Transactions to HM Treasury by the Scottish Government; and it can be used to finance the Bank's operating costs. In the short term this allows for indicative projections of the required Scottish Government contribution to the Bank's operating costs to the point at which it can entirely cover its own operating costs from its income.

To ensure that the developed financial model is robust we have engaged with the Government Actuarial Department who have undertaken an independent assurance exercise. They have advised that no material calculation error has been identified that would significantly alter the model's overall financial outcome.

The key findings of the 50 year profile model, based on assumed forecasts, are that:

- The Bank is projected to make cumulative investments of £17.5 billion. This is investment made directly by the Bank and does not account for investment leveraged from other sources.
- As a result, the initial £2 billion capitalisation would be recycled across the Bank's portfolio over 8 times across the 50 year period, including the initial investment.
- The Bank is projected to make a total profit after tax of £2.8 billion over the fifty years.

The latest version of the financial modelling also projects a total required Scottish Government contribution to the Bank's operating costs of around £17 million. This is broadly in line with the projections set out in the Financial Memorandum and is further supported by bottom-up modelling of operational costs. Further detail on this is set out at Annex A.

Existing arrangements and relationship with Scottish Enterprise

Once established the Bank will become Scotland's primary provider of mission-oriented public sector debt and equity. As the Committee will be aware, we are also committed to consolidating and streamlining the existing landscape of public investments so that access to support, advice and finance is simplified. The information set out here specifically relates to the Bank's relationship with Scottish Enterprise given the role SE's Scottish Investment Bank currently plays in supporting early stage investments.

Wider work is on-going to develop and cement the future relationship between the new Bank and the Scottish economic development ecosystem. This will include working with Highland and Islands Enterprise, the new South of Scotland economic agency, Scottish Futures Trust, and wider public service partners to build a pipeline of future investments in communities across Scotland, and to align the advice, support and finance that businesses need to prosper, whatever their size and wherever they are located.

The Scottish Government and Scottish Enterprise have been working together to co-design a transition framework. As I set out above, the transfer of relevant assets, business and people from SE's Scottish Investment Bank will be supported by transitional arrangements during the first years of the Bank's life. The final timetable for the transitional period will be agreed together by the Bank, Scottish Enterprise and the Scottish Government.

The initial stage will see the new Bank maximise its impact on delivering transformational large scale and mission-led investment activities, with SE providing specialist skills around early stage capital. Subsequent stages will see wider relevant investment activity transition to the Scottish National Investment Bank from Scottish Enterprise. By the end of this period, all relevant business will have transitioned from Scottish Enterprise to the new Bank.

This transitional process will be managed by the Scottish National Investment Bank, the Scottish Government and Scottish Enterprise. The arrangements are being designed to enable a smooth and effective transition by ensuring continuity for existing customers and partners, and supporting a seamless transfer of relevant staff, assets and activities once the Bank has been established. Through close collaboration during the transitional period, Scottish Enterprise will also adapt its investment activities to reflect the Missions of the Bank and ready itself for its re-focused role post transition through its ongoing transformation programme. This will include a particular focus on stimulating demand, developing complex regeneration projects and attracting foreign direct investment; and the roll out of a digital portal providing a single point of access for businesses.

Investments made during the transitional period will be made under the Scottish National Investment Bank or Scottish Enterprise brand with relevant SE investments transitioning from SE to the Bank at the end of this period.

The transition process will include the appropriate transfer of staff from Scottish Enterprise to the Bank. We recognise that this can be an unsettling process for the staff members involved and that line managers and the Unions have an important role in supporting staff through change. Trilateral engagement between the Scottish Government, Scottish Enterprise and Union representatives on the issue of transition has already been established and will continue throughout the transition period.

As I set out during the Stage 2 debate, Scottish Enterprise staff who are transferring to the Bank will not experience any detriment, and all relevant requirements and best practice in relation to employment rights and pensions will be closely followed.

Yours

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ANNEX A

FURTHER FINANCIAL MODELLING

As set out above, the financial modelling that has been conducted in respect of the Bank aims to identify a prospective profile of returns to the Bank over a 50 year period.

To achieve this a range of indicative financial product profiles have been developed which drive projections of the Bank's performance. These are a mixture of debt and equity product profiles and vary by: investment term; repayment profile; interest or dividend rates; failure and recovery rates. The profiles also vary by the proportion of investment allocated from the Bank's total investment capital available each year.

The total available investment for the Bank drives its investment profile. The available investment is derived from the profiled capitalisation by Scottish Government; redemption of said capital is to be recycled; and income received from investment returns, e.g. interest payments etc. The latter will go solely to the Bank's operating costs until the point at which the Bank can cover these costs in total, at which point additional income may, subject to Consolidated Budgeting Guidance, be reinvested.

The financial modelling also includes an anticipated profile of return on precursor investments – namely the Building Scotland Fund and other precursor investments referenced in the draft Budget 2019 – made by the wider Scottish Government which are intended for transfer into the Bank.

It should be noted that the Bank will set its own financial products and that the proportion of the Bank's capital invested in each will be driven by the demand received, and by the Bank's own decision-making. Both of these drivers will influence the profile of returns.

The financial model itself is capable of further revision as required by progress in operational planning and, in time, it can be a tool to reflect the Bank's own decisions.

The indicative projections of the required Scottish Government contribution to the Bank's operating costs are subject to further caveat. They result from projections of the Bank's operating costs but also the projected performance of precursor investments and the returns from the investment strategy to be developed by the Bank. As with any forecast financial model, assumptions cannot be taken as a full reflection of actual performance. The Scottish Government's contribution may therefore vary depending on the actual performance of the Bank. For example, should the Bank make more equity investments, or more patient and long-term loans than currently anticipated, which would delay the projected flow of income and cash back into the Bank and may in turn mean a lower contribution from income to its operating costs.

My response to the Committee's Stage 1 Report set out, in respect of setting a rate of return for the Bank in its early years, that the Scottish Government recognises the need for the Bank to address medium- to longer-term financial performance issues, particularly in its early years – such as securing an appropriately balanced portfolio and targeting and supporting the right businesses. It would therefore be entirely suitable for the Bank to wish to take decisions that would affect the profile of required Scottish Government contributions to operating costs. This would be handled through the annual budget process.

Operating costs

The Financial Memorandum published alongside the Bill in February 2019 set out projected staff and non-staff costs for the Bank[1]. Those indicative costs were benchmarked to and based on the experiences of comparator bodies. This produced the top down projection set out in the Financial Memorandum.

The updated financial modelling projections for operating costs have been produced informed by further operational planning for the establishment of the Bank. The operating costs are set out below.

	Part year	**Results in the next Parliament**					
	2020-21	**2021-22**	**2022-23**	**2023-24**	**2024-25**	**2025-26**	**Totals**
	£m	**£m**	**£m**	**£m**	**£m**	**£m**	**£m**
Non-staff costs							
Technology & IT	0.50	1.10	1.10	1.10	1.10	1.10	6.00
HR, recruitment, training	0.70	0.78	1.38	0.68	0.74	0.69	4.97
Public engagement	0.60	0.60	0.55	0.55	0.64	0.55	3.49
Premises	0.70	1.20	1.20	1.20	1.20	1.20	6.70
Professional services	1.20	1.50	1.50	1.40	1.48	1.30	8.38
Board costs	0.30	0.30	0.30	0.30	0.34	0.25	1.79
	4.00	**5.48**	**6.03**	**5.23**	**5.50**	**5.09**	**31.33**
Staff costs	**7.80**	**11.10**	**14.10**	**15.60**	**16.30**	**16.90**	**81.80**
Total non-staff and staff costs	**11.80**	**16.58**	**20.13**	**20.83**	**21.80**	**21.99**	**113.13**

The projected costs set out here remain subject to potential subsequent revision as operational planning for the Bank is completed, and depending on the decisions the Bank itself takes subsequent to its establishment.

The staff costs projections are based on modelled salary and pension costs based on the experience of comparator bodies. The overall staff plans come from evolving operational plans which seek to provide the Bank with the necessary staff resources when it opens. Once established, the Bank will take responsibility for the pacing and scale of its recruitment. Should the Bank choose a slower pacing or lower scale of further recruitment then the anticipated profile of operating costs would change accordingly. However, for the sake of the latest financial modelling it was thought prudent to take a higher estimate.

[1] Table 5, pg. 11; *Scottish National Investment Bank Bill Financial Memorandum* - https://www.parliament.scot/S5_Bills/Scottish%20National%20Investment%20Bank%20Bill/SPBill43FMS052019.pdf.

Scottish Government contributions to operating costs

These projections, when combined with the indicative product profiles in the financial modelling, allows us to project the required Scottish Government contributions to the Bank's operating costs to the point at which it is expected to be able to cover those costs itself.

The Financial Memorandum set out that: "The indicative financial modelling conducted to date indicates that costs on the Scottish Administration as a result of the operation of the Bank until it is able to break-even are estimated to be £17.9 million in total in resource budget requirement. The indicative financial modelling projects that the Bank will cover its operational costs from 2023/24."

The revised financial modelling has further supported this indicative finding, indicating that the Bank can be anticipated to cover its operating costs as of financial year 2023/24. The total forecast allocation of Scottish Government contributions of £17 million between 2020-24 remains within the envelope previously set out.

ANNEX B

SCOTTISH NATIONAL INVESTMENT BANK BILL – STAGE 2 MATTERS ARISING

Inclusive Growth

During the Stage 2 Debate some Committee members raised the definition of "inclusive growth". As you will recall, I wrote to you on 21 November 2019 regarding the Committee's report on 'Scotland's Economic Performance' with an update on commitments. That included setting out the Scottish Government's position in respect of 'inclusive growth'. For the benefit of members I have reproduced the relevant extracts from that letter below:

> "The Scottish Government has a consistent definition of inclusive growth, which is growth that combines increased prosperity with greater equality, creates opportunities for all, and distributes the dividends of increased prosperity fairly.
>
> "The Scottish Government has developed an inclusive growth outcomes framework and data tool – focused on the 5 "Ps" of Productivity, Participation, Population, People and Place, as well as sustainability – published on Scotland's Centre for Regional Inclusive Growth (SCRIG): https://www.inclusivegrowth.scot/. This is aligned with the National Performance Framework and helps set out the core aims of inclusive growth for policy makers and practitioners and aims to ensure a consistent understanding of what inclusive growth is and how it is to be measured.
>
> "That definition, backed up by the Fairer Scotland duty, provides strategic direction to policy interventions and programmes across Government, by enterprise agencies and by other public services.
>
> "At a strategic level, our Economic Strategy is absolutely clear that inclusive growth means, for example:
>
> (1) Promoting fair work and good quality jobs – through, for example, our Labour Market Strategy, the Fair Work Framework, and our Fair Work First approach through which we fair work conditionality will be attached to public sector grants, funding streams and contracts;
> (2) Promoting equality and tackling inequality – through, for example, free childcare, action on women's enterprise and action to increase the employment of women and disabled people; and
> (3) Focusing on place – ensuring that success and opportunity is shared across all of Scotland.
>
> "That is reflected in our Letters of Strategic Guidance to the enterprise agencies.
>
> "However, we recognise that it is also important to allow for some flexibility at a local level – so that priorities in different places and amongst different groups of people can be reflected in the process and practice of inclusive growth. Our inclusive growth outcomes framework and data tool therefore provide this flexibility, allowing for the addition of these priorities to the framework.

Further detail is included in my letter of 21 November.

Minimum Ethical Standards

At Stage 2 we debated the establishment of 'minimum ethical standards' for the Bank following the lodging of amendment 33 in the name of Rhoda Grant MSP, and related amendment 37 in the name of Dean Lockhart MSP.

As I set out in my remarks at Stage 2, it is normal policy for public or private sector investors to set out which sectors or activities they would exclude or restrict in terms of their investments. This will be the key component in the institution's minimum ethical standards. This will supplement the Bank's legal compliance which would mean, for example, that it would not engage with organisations that perpetrated tax evasion. I also set out at Stage 2 that the Bank must develop and communicate its own approach to investment.

The Bank's 'minimum ethical standards' will be an important tool in its investment decision-making. Establishing which sectors or activities are 'excluded' (i.e. those in which the Bank will not invest) or 'restricted' (where the Bank will not normally invest but may do in certain circumstances e.g. as it makes a significant contribution to one of its missions) will provide clarity to the Bank in its own decision-making, and also to prospective customers and co-investors. I respect that opinions as to whether a particular sector or activity is excluded or restricted may differ. There is therefore a need for transparency as to the approach that the Bank takes.

I appreciate that Members have an interest in the prospective content of a minimum ethical standards policy. There were also questions raised at Stage 2 as to how the Bank will have the certainty it requires to develop and implement its approach to investment. I have therefore set out our planning below for the development of the Bank's 'minimum ethical standards', including the role of Ministers. I can also clarify that we would expect the Bank to make its minimum ethical standards publically available.

The Bank's minimum ethical standards policy must be sufficiently flexible that it can be updated as necessary to account for changes in the context in which the Bank is operating. It is also necessary for the Bank to have ownership of the policy and to make changes as it deems necessary, within the bounds set out below, to ensure that it continues to function effectively. For these reasons we would not, on balance, support the setting out of minimum ethical standards in primary legislation or otherwise in a document which requires parliamentary approval for any changes to it.

The Bank will use its minimum ethical standards when making investment decisions. Investment managers will recommend investments in line with the standards. Recommendations for investment in 'restricted' activities or sectors will be considered by the investment decision-making body (such as an investment committee) which will, in turn, be able to escalate an investment decision should it require additional oversight. Ultimately the Board will have responsibility for ensuring that the Bank's investment decision-making is in line with its minimum ethical standards (and other requirements) and that these remain fit for purpose.

This is in line with the 'three lines of defence' model for handling risk with which the Committee may be familiar and which is commonly deployed in corporate bodies. In the case of the Bank this will be made up of investment managers (who own and manage risk – the first line of defence), an investment decision-making body (who oversee or specialise in risk management

– the second line of defence) and the Board supported as they see fit by other resources including internal audit (who provide assurance for risk management systems – the third line of defence). The second line of defence jointly incorporates legal, compliance, risk and finance functions, ensuring that decisions are not made in isolation.

As regards the role of Ministers, my letter of 16 May 2019 set out that the main formal instrument governing the relationship between the Scottish Ministers, as sole shareholders, and the Bank's Board will be a shareholder framework. This will be the chief means by which Ministers can express their expectations for the Bank.

It is my intention to set out in that document Scottish Ministers' expectations in respect of the Bank's minimum ethical standards. These will be that, first and foremost, the standards developed should support the Bank's work to meet the missions set for it, and should not contradict them. The standards should then support Scottish Government policy and not cut across it. In practice this would mean that, for example, investment in munitions would be excluded, as is the case for other Scottish Government and enterprise agency activities.

Committees/Ethical Investments

A number of members lodged amendments at Stage 2 which proposed establishing an ethics committee for the Bank. I set out then in my remarks that I did not think providing for an ethics committee in legislation was desirable on grounds of both effectiveness and flexibility. However, the intention behind the amendments – ensuring that the Bank's investment decision making incorporated ethical considerations – is one with which I am sympathetic.

I will therefore bring forward amendments for consideration at Stage 3 which provide for a remit for the Bank's Board, but not prescribe a structure for the Bank with the attendant effectiveness and flexibility issues.

I also wanted to take this opportunity to clarify a point raised in the Stage 2 debate. Currently section 9 of the Bill provides that the Bank's directors shall establish an Audit Committee and a Risk Committee, and sets out the key aspects of the remit of each.

The UK Corporate Governance Code sets out best practice for handling of audit and risk; and it requires listed companies to establish Audit and Risk Committees chaired by non-executive directors of the board. Given the importance of providing assurance that these two issues will be handled robustly in an institution like the Bank, and the fact that we expect the Bank, as a limited company, to follow best practice as well as legal requirements, in matters of corporate governance, we considered it appropriate to exceptionally include the provisions in section 9.