Scottish National Investment Bank Fairer Scotland Duty Assessment

September 2019

Scottish Government
Riaghaltas na h-Alba
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SCOTTISH NATIONAL INVESTMENT BANK FAIRER SCOTLAND DUTY ASSESSMENT

EXECUTIVE SUMMARY

ABOUT THIS FAIRER SCOTLAND DUTY ASSESSMENT

1. The Scottish Government has committed to establishing the Scottish National Investment Bank (the Bank) which will be operational investing in businesses and communities across Scotland in 2020. The creation of the Bank will deliver an institution that can boost Scotland's economic performance and realise the Scottish Government's ambitions for the economy by providing patient capital to finance growth. The Bank's investment decisions will reflect financial, economic and wider social and ethical interests in order for it to have the desired impact, contribute to inclusive growth and fulfil the objectives set for it.

2. As set out in the Implementation Plan, the role of the Bank is to "…provide finance and act to catalyse private investment to achieve a step change in growth for the Scottish economy by powering innovation and accelerating the move to a low carbon, high-tech, connected, globally competitive and inclusive economy."[1] Understanding success within the context of this vision mean that the Bank cannot be judged solely on the basis of financial returns but that its performance must also be assessed against social and environmental returns as well as the wider economic benefits arising from the Bank's activities. In that way the Bank will be an institution that is both commercially-minded and publicly accountable and one that is capable of investing to positive effect in communities and businesses across Scotland.

3. The Fairer Scotland Duty, Part 1 of the Equality Act 2010, came into force in April 2018. The Duty places a legal responsibility on public bodies in Scotland to pay due regard to how they can reduce inequalities of outcome arising from socioeconomic disadvantage. Interim guidance on applying the Fairer Scotland Duty was published in March 2018 as part of a three year implementation phase. This is to allow consideration to be given to any adaptations that may be necessary so that public bodies understand their responsibilities arising from the Duty and implement them effectively.

4. To fulfil their obligations under the Duty, public bodies must be able to demonstrate that they have actively considered how they can reduce inequalities of outcome arising from socioeconomic disadvantage in any major decisions that they take. The scope and scale of the Bank's activities give it the levers to have a direct impact on reducing socioeconomic disadvantage in Scotland. As such this FSDA will actively consider what opportunities are available to the Bank in reducing socioeconomic disadvantage rather than focusing on how it can address those inequalities of outcome that arise from the experience of poverty. These inequalities of outcomes will be addressed by reducing socioeconomic disadvantage directly.

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[1] Scottish National Investment Bank Implementation Plan, p. vi

5. Establishing the Bank is a significant undertaking with a number of key strategic decisions involved in its creation including setting missions, producing an investment strategy and developing an ethical statement. The content of both the investment strategy and ethical statement are a matter for the Bank itself. Moreover, work is ongoing to develop missions for the Bank and the Fairer Duty Scotland will be applied to the missions-setting process. This iteration of the FSDA will centre on the decision to establish the Bank, as such this FSDA gives guidance to the Scottish Government on how it can optimise the Bank towards reducing socioeconomic disadvantage during the build phase. It also sets out evidence for the Bank to consider once it is operational on how its activities can be conducted in a way which contributes towards reducing socioeconomic disadvantage.

6. A variety of methods have been used to inform the development of this FSDA including engagement with experts and stakeholders, the results of both public consultations on the Scottish National Investment Bank, the outcomes of the Economy, Energy and Fair Work Committee's scrutiny of the Bill as well as extensive desk-based research. In addition, an expert Panel including representation from key stakeholders was convened on two separate occasions to provide their perspective on how the Bank might contribute to reducing poverty in Scotland.

7. The outcomes of this Assessment demonstrate that the Bank has considerable potential to reduce socioeconomic disadvantage but finds that active steps must be taken by the Scottish Government during the build phase and by the Bank itself once established, in order, to realise this potential. It is important, however, not to place unrealistic expectations on the Bank regarding the impact it can have on reducing socioeconomic disadvantage. By working in conjunction with public sector partners and within the context of existing Scottish Government policy, the Bank can make a tangible contribution in this regard in its role as commercial lender but it is by no means a challenge that the Bank itself can solve. The Bank must have structures that enable it to evolve its response to reducing socioeconomic disadvantage as it matures as an institution and should be given the time and space to do this. It is, however, important to note that the Bank must operate on a commercial platform if it is to be financially viable and anything it does to address socioeconomic disadvantage must take this into account.

8. This Assessment concludes that the Bank can contribute towards reducing socioeconomic disadvantage by:
   - improving access to finance for socioeconomically disadvantaged entrepreneurs;
   - improving access to finance for firms with characteristics that contribute to poverty reduction; and
   - introducing loan covenants.

9. In addition, this Assessment makes clear recommendations to the Scottish Government on steps that it can take in the establishment of the Bank to best support its contribution towards reducing socioeconomic disadvantage.

IMPROVING ACCESS TO FINANCE FOR SOCIOECONOMICALLY DISADVANTAGED ENTREPRENEURS

10. Establishing a successful business can offer a potential route out of poverty for those who are socioeconomically disadvantaged. Where a business is successful, studies have found that it translates into increased income, more flexible working conditions, more stable employment and enhanced job satisfaction. Socioeconomically disadvantaged entrepreneurs experience specific challenges when establishing a business, not least in accessing capital. This FSDA has identified a range of barriers that socioeconomically disadvantaged entrepreneurs in Scotland face in accessing credit from private lenders which means that viable businesses aren't getting the funding they require.

11. This FSDA concludes that the Bank, as a 'cornerstone in Scotland's economic architecture', can play a key role in addressing this market failure. There are several opportunities for it to do so such as by contributing to a clearer understanding of the gap in provision for credit to socioeconomically disadvantaged entrepreneurs and considering its role in increasing the proliferation of financial products aimed at addressing the barriers to accessing finance identified within this Assessment. It further concludes that the Bank should consider how it can work with partners across the public sector to build increased financial awareness and business skills among entrepreneurs and potential entrepreneurs in Scotland.

IMPROVING ACCESS TO FINANCE FOR FIRMS WITH CHARACTERISTICS THAT CONTRIBUTE TO POVERTY REDUCTION

12. Research has identified specific firm-level characteristics that have an inherent impact on reducing poverty, specifically microbusinesses and firms that use non-pyramidal company ownership models. Research shows that these businesses also experience distinct challenges in accessing the credit they require compared to larger firms and those which use more established company models.

13. This FSDA concludes that further analysis into the gap in provision of finance in Scotland for microbusinesses and companies that democratise the economy should be conducted. The Scottish Government will publish its findings on Access to Finance for SMEs in early 2020 and the Bank should factor these into how it works with partners across the public sector to reduce the barriers that microbusinesses and companies that democratise the economy face in accessing appropriate forms of finance as identified within this FSDA. This includes identifying specific financial instruments to overcome these market and institutional barriers as well as actions to reduce borrower discouragement. The Scottish Government will also consider what actions it should take in light of the review's findings.

INTRODUCING LOAN COVENANTS INCLUDING FAIR WORK FIRST

14. Although not every business that the Bank will invest in will have inherent characteristics that reduce socioeconomic disadvantage as a matter of course, opportunities exist for the Bank to influence the activity and behaviour of those firms that it invests in through loan covenants. These are already used by banks and other financial institutions to attach conditions designed to protect or enhance the value of their investments.

15. There are opportunities to build existing Scottish Government policy into the operation of the Bank through introducing Fair Work First to its commercial investments. In addition, the Assessment concludes that the Bank may wish to attach community benefit clauses to high value investments while also placing a requirement on firms that it lends money to join a business network. Research has revealed that attaching conditions to investments is a significant source of borrower discouragement and so the Assessment emphasises the importance of adopting a tailored approach to introducing loan covenants due to concerns that businesses will be deterred in seeking credit from the Bank.

BUILDING POVERTY REDUCTION INTO THE BANK'S GOVERNANCE

16. The Bank's governance structures must also reflect a commitment to reducing socioeconomic disadvantage to ensure that this is built into the foundations of the Bank instead of being an additional element of its activity. This FSDA recommends specific steps that the Scottish Government must take in building the Bank to create an institution that can make a tangible contribution to reducing socioeconomic disadvantage in Scotland. These steps include amending the ancillary objects contained within the Scottish National Investment Bank Bill (the Bill), developing metrics to assess the Bank's contribution to reducing socioeconomic disadvantage and including representation from groups able to reflect the voice of those with lived experience of poverty on the Bank's Advisory Group.

FAIRER SCOTLAND DUTY CONCLUSIONS AND RECOMMENDATIONS

The Fairer Scotland Duty Assessment recommends that the Programme Team:

1. review the ancillary objects contained within the Scottish National Investment Bank Bill as drafted to best align the objectives of the Bank with the purpose of the Fairer Scotland Duty, utilising its position as a ‘cornerstone in Scotland’s economic architecture’ to shape an economy that is diverse, democratic and enhances societal wellbeing.

2. develop a series of metrics against which to assess the contribution of the Bank towards reducing socioeconomic disadvantage in Scotland. These metrics should seek to assess the performance of the Bank in this regard across the full range of its activities to develop a holistic picture its contribution. This could be achieved through the balanced score-card approach referenced in the Implementation Plan and the Economy, Energy and Fair Work Committee’s Stage 1 Report.

3. ensures that the voice of those with lived experience of poverty is represented in membership of the Advisory Group so that Scottish Ministers have access to expert advice on the contribution of the Bank in helping to reduce socioeconomic disadvantage and ensuring that the Bank evolves its activities in response to the changing characteristics of poverty over time.

This Fairer Scotland Duty Assessment concludes that the Bank should consider how it can:

4. in light of the findings of this Fairer Scotland Duty Assessment, contribute to an investment landscape which actively removes barriers to accessing finance for socioeconomically deprived entrepreneurs. The Bank should consider the development of financial products that are tailored to the needs of these businesses where they are not already available through other bodies. Where necessary the Bank should conduct or commission robust and transparent analysis of the gap in provision of credit for these businesses to inform its role. Similarly, the Bank may also consider its role in relation to removing barriers to accessing finance for microbusinesses and firms with company models that democratise the economy.

5. support relevant partners across the public sector to improve awareness among entrepreneurs about the types of financial products available to them when seeking to start or scale up their business, and develop core skills required to make their business a success. In addition, the Bank can communicate its suite of financial products to other lenders so that they are fully aware of the finance available and can refer entrepreneurs and businesses seeking such support, where appropriate.

6. positively contribute to market intelligence and formation of evidence-based decisions by improving understanding in the market place of access to finance

issues, especially those arising from information asymmetries in relation to some firms, for example those companies that contribute to reducing socioeconomic disadvantage such as microbusinesses, including establishing and publicising the accessibility of those categories of firms to lending by financial institutions.

7. work with the businesses that it invests in to embed Fair Work First. A tailored approach to embedding these informed by engagement with the business community should be adopted to avoid stymieing demand from SMEs and from organisations that deliver social value in other ways, such as charities. With reference to reducing inequalities of outcome arising from socioeconomic disadvantage within the context of the Fair Work principles, training and upskilling of staff can have particularly positive outcomes for businesses that receive investment and their employees.

8. encourage those businesses that it invests in to join a business association or to find other networking opportunities that will enable them to learn and share best practice with those who have similar growth, innovation and business practice ambitions.

9. introduce community benefit clauses aimed at reducing inequalities of outcome arising from socioeconomic disadvantage as loan covenants to particularly significant high value investments where relevant. This may include encouraging organisations who receive large sums of money from the Bank to review their procurement practices to, for example, incorporate more Scottish and locally-based businesses into their supply chain where possible.

BACKGROUND TO THE SCOTTISH NATIONAL INVESTMENT BANK

1. The Scottish Government's Council of Economic Advisors highlighted the important role that national investment banks play in providing long-term investment to support economic growth in many European countries. In the Programme for Government 2017-18, the First Minister announced plans to establish a Scottish National Investment Bank. Former CEO of Tesco Bank, Benny Higgins, supported by a small advisory group, led the work on developing an Implementation Plan. The Plan was published in late 2018 following a public consultation.

2. The Cabinet considered in detail the proposals outlined in the Implementation Plan and responded to the plan in a Parliamentary debate in May 2018 agreeing to accept all 21 recommendations. In the Programme for Government 2018-19, the First Minister announced plans to introduce legislation to formally underpin the Bank. Having received Parliamentary support, the Scottish Government are now taking forward the implementation of these recommendations under various workstreams. In the Draft Budget 2018-19, the Scottish Government announced the Building Scotland Fund (BSF) as a precursor to the Bank.

3. As a public limited company the Bank is required to have set out in its Articles of Association its company objects; these are provided in the Bill. The main object for which the Bank is established is the giving of financial assistance to commercial activities for the purpose of promoting or sustaining economic development or employment in Scotland. The Bill also sets out ancillary objects for the Bank in pursuit of its main object.

4. The Bank will in general take a mission-based approach to its investment. Scottish Ministers will set out missions for the Bank to guide its activities and ensure alignment between the activities of the Bank and Scottish Government policy. The missions set for the Bank are expected to be assessed every 5 years. Any amendment of the missions, or development of subsequent missions, will also be informed by the review which the Bill requires Scottish Ministers to commission at least every 5 years.

5. The Bill was laid before the Scottish Parliament on 28 February 2019 and was scrutinised by the Economy Energy and Fair Work Committee (the Committee) across May and June of that year. The Committee published its Stage 1 Report on the Bill was published on 4 July 2019 and made a series of recommendations to the Scottish Government regarding possible changes to the Bill and to features of the Bank. The includes a recommendation to clarify the wording of the ancillary objects within the Bill to enshrine the delivery of social value as a key role of the Bank.

IMPROVING ACCESS TO FINANCE FOR SOCIOECONOMICALLY DISADVANTAGED ENTREPRENEURS

6. Starting a business through successful entrepreneurship has the potential to be a route out of poverty for those who are socioeconomically disadvantaged. Research has demonstrated that for those who establish a profitable business, self-employment translates into increased income, more flexible working conditions, more stable employment and enhanced job satisfaction.[2] For those who are socioeconomically disadvantaged self-employment can not only offer the opportunity to alleviate financial hardship but also reduces many of the inequalities of outcome that typically accompany poverty. The idea of becoming an entrepreneur therefore holds a particular attraction for those who are socioeconomically disadvantaged.

7. Studies, however, have shown that groups who experience disadvantage in the labour market, and are therefore more likely to experience poverty, also demonstrate substantially lower levels of self-employment than the general population.[3] Indeed socioeconomically disadvantaged entrepreneurs experience significant challenges when seeking to start a business, challenges that not only determine success or failure but also impact on the future productivity, innovation and profitability of that firm.

8. Responses to both consultations held by the Scottish Government on the Bank as well as the Committee's Call for Evidence on the Bill emphasised the role of the Bank in addressing these inequalities by ensuring that it is an institution that has the capability to invest in anyone with a solid business proposal.

Barriers to Accessing Finance

9. Numerous studies have been conducted with the aim of identifying and better understanding barriers to accessing credit for socioeconomically disadvantaged entrepreneurs. The outcomes from this research has demonstrated that access to finance constitutes a significant challenge for these individuals.[4] In the first instance, lower levels of personal wealth and fewer opportunities to secure start-up capital from family and friends means that they are more likely to require external sources of finance in order to establish a business.[5]

10. There are, however, a series of obstacles for socioeconomically disadvantaged entrepreneurs in their attempts to secure capital from external sources such as

[2] A. Atherton, D. Wu and Z. Wu, 'Self-exploitation or successful entrepreneurship? The effects of personal capital on variable outcomes from self-employment' *Journal of Small Business and Enterprise Development*, Vol. 25, Issue, 2018, p. 866.
[3] M. Wishart, 'Under-represented Entrepreneurs: A Literature Review', *Enterprise Research Centre*, 2018, p. 6
[4] 'Policy Brief on Access to Business and Start-up Finance for Inclusive Entrepreneurship', *Organisation for Economic Co-operation and Development (OECD)*, 2014, p. 3
[5] 'Policy Brief on Access to Business and Start-up Finance for Inclusive Entrepreneurship', *(OECD)*, p. 5

banks and financial institutions. These barriers exist on both the supply and demand-side meaning that while the inherent characteristics of capital markets and the credit rationing practices of financial institutions create obstacles for socioeconomically disadvantaged entrepreneurs in accessing the requisite finance, individuals from these groups are also less likely to apply for funding in the first place.[6] Studies have, however, shown that failure to secure finance when businesses have a requirement to do so has a significant impact on the features of what makes a business successful such as its growth, productivity and innovativeness.

11. Alternatively, entrepreneurs may utilise suboptimal forms of finance such as credit cards or bank overdrafts to fund the set up costs for their business which can result in higher repayments coupled with less defined repayment schedules. When determining how to reduce socioeconomic disadvantage the Bank must therefore consider how it addresses both these demand and supply-side barriers. In light of the implications that access to credit has on the ability of socioeconomically disadvantaged entrepreneurs to establish and maintain a successful business, this section will consider what barriers they face in securing capital and how the Bank can seek to improve access to finance for them. It will focus primarily on debt as opposed to equity finance due to its greater prevalence within the Scottish economy and the fact that it is more closely aligned to the characteristics of businesses typically established by socioeconomically disadvantaged entrepreneurs.

Proof of Concept

12. The financial growth cycle theory states that funding the processes required to prove whether a product is marketable, generally referred to as proof of concept, is typically done through insider finance, that is to say it is funded through an entrepreneur's personal wealth or by raising capital from family and friends. Anecdotal evidence provided by Scottish entrepreneurs engaged in the sale and development of specific products reinforces the assumptions inherent in the financial growth cycle theory. Those entrepreneurs who shared their experience stressed that they relied heavily on personal wealth and drew on capital from families and friends to finance development of their product or business idea.

13. The importance of insider finance in funding this stage of the business lifecycle arises largely from a lack of provision available through private investors many of whom are unwilling to assume the risk of investing in a product or idea that hasn't been proven to be a marketable product, a key aspect of what is known as a business being 'investor-ready'. In fact it is this very issue, albeit at a larger scale, that is at the heart of the rationale for establishing the Bank in the first place. As Mariana Mazzucato has highlighted in her work, financial institutions in the UK are typically adverse to investing where there is less certainty of achieving returns or where these returns are realised over a long time horizon. Indeed the Scottish Government has already committed to making the Bank a source of patient strategic finance to address this shortage in provision.

[6] 'Policy Brief on Access to Business and Start-up Finance for Inclusive Entrepreneurship', *OECD*, p. 10

14. While the reticence of private investors to make credit available for proof of concept testing is understandable, it does inherently handicap socioeconomically disadvantaged entrepreneurs in proving to themselves and others that they have a viable business proposition. Significantly lower levels of personal wealth coupled with fewer opportunities to raise the necessary capital from family and friends mean that they are heavily reliant on external sources of funding in order to make their business idea a reality. The lack of financial products available to fund proof of concept and the requirement this places on entrepreneurs to self-fund this phase means that those who are socioeconomically disadvantaged are often simply unable to access the finance that they require to develop the product or business idea that offers them a route out of poverty.

Firm-level characteristics

15. While the Financial Growth Cycle model developed by Udell and Berger highlights the importance of insider finance to the start-up phase across all types of business, private investors in the UK including banks and building societies do offer credit for new and emerging businesses entering an established market. Data pertaining to the experience of Scotland's socioeconomically disadvantaged entrepreneurs in securing capital has not been collected at sufficient scale or in enough detail to provide reliable evidence of specific obstacles that they experience in accessing finance. Detailed research into the specific characteristics of businesses established by those who face socioeconomic disadvantage has, however, found that they typically exhibit specific features. In particular, firms established by socioeconomically disadvantaged entrepreneurs tend to be and remain small[7] and are clustered in specific sectors such as retail, hospitality and care.[8]

16. By analysing the experience of businesses within these sectors in accessing finance through information made available in the UK Government's Longitudinal Small Business Survey (LSBS) it is possible to gain insight into the experience of socioeconomically disadvantaged entrepreneurs in securing capital from private investors. This analysis demonstrates that sectors where businesses created by socioeconomically disadvantaged entrepreneurs are typically clustered have a lower probability of securing a loan from a bank or financial institution compared to other types of business, particularly high-tech and knowledge intensive companies:
    a. **Success in securing full value of loan sought from bank/building society according to business type:** 42% of loan applications for businesses in the care sector were successful in receiving the full value of the loan they sought. Comparatively, 83% of primary industry businesses, 61% of manufacturers and 68% of small and medium-sized enterprises (SME) operating in professional, scientific or technical sectors received the full value of the loan they sought.

[7] R. Blackburn and D. Smallbone, 'Sustaining Self-Employment for Disadvantaged Entrepreneurs: A Background Paper for the OECD Centre for Entrepreneurship, SMEs and Local Development', *Organisation for Economic Co-operation and Development (OECD),* P. 1
[8] Blackburn and Smallbone, 'Sustaining Self-Employment for Disadvantaged Entrepreneurs', P. 8

b. **Reasons for being rejected for loan from a bank/building society according to business type**: Although businesses operating in the retail sector had a relatively high approval rate for loan applications, a large proportion of those rejected were done so on the basis that the lender was 'not interested in their sector or business type'.

c. **Outcome of Application for Government or local authority grant or scheme according to business type**: Businesses operating within the retail, hospitality and care sectors have some of the highest rates of securing loans or grants from public sector sources. Last year 75% of retail, 87% of accommodation and food sector and 88% of care businesses were successful in securing some or all of the funding they sought from this source.[9]

17. Results from the LSBS clearly demonstrate that specific sectors of the economy, particularly where businesses started by socioeconomically disadvantaged entrepreneurs are clustered, experience challenges in accessing finance. Significantly, the public sector plays a key role in addressing the shortfall in finance for these sectors from private lenders. Interestingly, the LSBS reveals that the proportion of businesses which have an application rejected on the basis that their proposals lack commercial viability is lower within these sectors than it is among those types of business that are typically more successful in obtaining finance. It is also worth drawing attention to the findings of the recent IPPR Scotland report entitled 'How Productivity could Deliver Inclusive Growth in Scotland' which highlights the importance of ensuring that productivity gains are shared across all sectors of the economy in Scotland and makes specific mention of sectors where low paid staff are clustered.

Information Asymmetries and the Requirement for Collateral

18. Socioeconomically disadvantaged entrepreneurs experience additional challenges in accessing finance arising from information asymmetries. Financial institutions are using increasingly digitised and data-led methods to inform their decision-making around whether to invest in specific businesses. Newer and smaller firms are particularly vulnerable to the influence of information asymmetries due to a lack of 'hard' evidence against which banks and financial institutions can determine the degree of risk associated with lending to a specific business.[10] Where investors lack sufficient information to assess the viability of business proposals they will seek to secure the value of their investment against tangible assets, collateral, which can be seized in case of default. Since those who are socioeconomically disadvantaged own fewer assets that can be used to secure loans, such as property, they are significantly more likely to be rejected by traditional private sector lenders.[11]

19. Returning to the 2018 LSBS and this time using size of firm as a proxy for businesses established by socioeconomically disadvantaged entrepreneurs, the results show that the smaller the firm the less likely it is to secure capital from

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[9] UK Government, '2018 Longitudinal Small Business Survey'
[10] 'Innovation, SMEs and the Liability of Distance: The Demand and Supply of Bank Funding in UK Peripheral Regions', *Journal of Economic Geography*, Vol 17, 2017, P. 236
[11] Policy Brief on Access to Business and Start-up Finance for Inclusive Entrepreneurship, p. 10

private lenders. Take, for example, commercial mortgage applications, where real estate is used as collateral for a business loan. The LSBS shows that the smaller the firm the less likely they are to be successful in applying for a commercial mortgage. Whereas 86% of medium-sized businesses secured all of the funding they applied for through a commercial mortgage, the equivalent figure was 52% for microbusinesses and just 28% for companies without any employees. Given that, alongside credit cards, commercial mortgages are the most commonly sought type of business finance from banks[12], the implications inherent in this disparity in access to credit are significant. In fact socioeconomically disadvantaged entrepreneurs in Scotland appear to be at a particular handicap in their pursuit of external finance relative to other European countries due to a preference among UK banks to use property as collateral against which to secure business loans.[13]

Borrower Discouragement

20. A study exploring barriers to entrepreneurship for poorer communities conducted in disadvantaged parts of Leeds demonstrated that demand-side barriers could be equally as impactful as those on the supply-side in restricting access to credit for socioeconomically disadvantaged entrepreneurs. The outcomes of the study identified concerns about accessing the requisite finance as a key restraint on people from poorer communities seeking to become entrepreneurs with almost a third of those who were surveyed listing it.[14] These findings have since been supported by a more generic study exploring access to finance for businesses in disadvantaged urban neighbourhoods. This study concluded that perceptions around their ability to access finance was the only significant barrier that firms located in disadvantaged communities actually faced in securing capital and that these views were pervasive among business owners.[15]

21. The 2018 LSBS explores the reasons why companies without employees are deterred from seeking finance which provides some insight into what discourages entrepreneurs and potential entrepreneurs from disadvantaged communities in their pursuit of external capital. Fear of being rejected (45%), not knowing where to find appropriate finance (25%) and poor credit history (19%) all feature prominently on this list.[16] It is evident that there are a range of factors at play which deter entrepreneurs and potential entrepreneurs from socioeconomically disadvantaged backgrounds from coming forward for finance to start a business and that these are acting to depress demand coming from these individuals.

[12] British Business Bank, '2018 Business Finance Survey: SMEs', p. 26
[13] IPPR Commission on Economic Justice, 'Prosperity and Justice: A Plan for the New Economy', *Polity Press*, 2018, p. 38
[14] N. Williams and C. Williams, 'Tackling Barriers to Entrepreneurship in a Deprived Urban Neighbourhood', *Local Economy,* Vol. 26, Issue 1, 2011 P. 36
[15] N. Lee and E. Drever, 'Do SMEs in Deprived Areas Find it Harder to Access Finance? Evidence from the UK Small Business Survey', *Entrepreneurship and Regional Development*, 2014, P. 8
[16] UK Government, '2018 Longitudinal Small Business Survey'

Access to working capital

22. Once a company has been successfully established the next point at which entrepreneurs typically require credit is when they are seeking to scale up. Scaling up can broadly be defined as a short period of high growth for a company when its operations expand significantly relative to its size at the beginning of the high growth period. Although scale up companies are usually thought of as operating in the technology and digital spaces, firms across all sectors of economy have periods of rapid expansion that requires capital to facilitate. The evidence shows that companies owned by socioeconomically disadvantaged entrepreneurs tend to remain microbusinesses which suggests that they struggle to achieve their growth ambitions.

23. Access to working capital has been identified as a key challenge for socioeconomically disadvantaged entrepreneurs in Scotland. In effect, covering the costs of fulfilling a specific order in the intervening period between conducting that job and payment for completing it is a particular challenge for those firms where the owner doesn't have personal savings or the ability to borrow from friends and family. The implications of not being able to secure the working capital that they require to cover the costs of delivering an order are significant and can result in businesses not being able to take on contracts that will allow them to expand thereby acting as a brake on the growth aspirations of that company.

24. Data published by the British Business Bank (BBB) appears to show a substantial shortage in provision of financial products across the UK designed specifically to enable firms to access the working capital that they require. In 2018, 40% of firms who sought finance did so in order to access working capital and of those businesses,[17] 37% stated that their reason for doing so was to cover a short term gap until funds were received from customers.[18] Despite the prevalence of businesses that have a requirement for working capital and the clear advantages of utilising supply chain finance over other types of product, the uptake of these types of financial products by businesses across the UK is low. While over half of SMEs surveyed by the BBB were aware of these products, significantly fewer knew who to approach in order to secure this type of loan. Considering Scotland specifically, the results of the 2018 LSBS show that only 1% of SMEs had applied for supply chain finance in the previous 12 months, the lowest percentage of any of the UK nations indicating a particular shortage in Scotland.[19] Either there is insufficient provision of this type of finance in Scotland or demand for this type of loan is not being adequately generated.

Conclusions

25. The LSBS reveals that there are a number of barriers that socioeconomically disadvantaged entrepreneurs experience in accessing the credit that they require to build a successful business. On the one hand, they have less capacity to self-fund when establishing or expanding their business yet the credit rationing

[17] British Business Bank, '2018 Business Finance Survey: SMEs', p. 30
[18] British Business Bank,'2018 Business Finance Survey: SMEs', p. 24
[19] UK Government, '2018 Longitudinal Small Business Survey'

practices adopted by financial institutions create obstacles to securing that funding externally. In addition, socioeconomically disadvantaged entrepreneurs are more likely to be discouraged from seeking business finance which means that they are less likely to come forward in the first place.

ADDRESSING THESE BARRIERS

26. Given the legal obligations arising from the Fairer Scotland Duty, it is evident that the Bank, once it becomes operational, will be required to consider how it can contribute to reducing the clear barriers that exist to accessing finance for socioeconomically disadvantaged entrepreneurs. The Bank cannot do this in isolation and must collaborate with partners across the public sector and beyond to implement those measures that will be successful in helping to mitigate these barriers. Action is necessary across the full range of demand and supply-side barriers identified above to ensure that all entrepreneurs with a viable business proposal, irrespective of their socioeconomic status, have the ability to access the capital they require to realise their ambitions. In order to achieve this, this FSDA suggests that the Bank, once established considers how it can:

    a. **contribute to an investment landscape which actively removes barriers to accessing finance for socioeconomically deprived entrepreneurs. The Bank should consider the development of financial products that are tailored to the needs of these businesses where they are not already available through other bodies. Where necessary the Bank should conduct or commission robust and transparent analysis of the gap in provision of credit for these businesses to inform its role.**

       Through the LSBS it is possible to see the scope but not the scale of the handicap experienced by socioeconomically disadvantaged entrepreneurs. While the LSBS is able to reveal what the barriers are it is unable to provide insight into the number of entrepreneurs with a viable business proposition who are unable to access the finance they require on account of their socioeconomic status. Without understanding the full gap in funding that exists for socioeconomically disadvantaged entrepreneurs any steps that the Bank takes in conjunction with public sectors partners to reduce these obstacles will ultimately be replaced by other credit rationing practices which could cause disadvantage in other ways. This FSDA therefore suggests that a full analysis into the gap in provision of credit for socioeconomically disadvantaged entrepreneurs is undertaken to inform the steps that should be taken to address this issue.

    b. **support relevant partners across the public sector to improve awareness among entrepreneurs about the types of financial products available to them when seeking to start or scale up their business, and develop core skills required to make their business a success. In addition, the Bank may wish to communicate its suite of financial products to other lenders so that they are fully aware of the finance available and can refer entrepreneurs and businesses seeking such support, where appropriate.**

Evidence shows that entrepreneurs are increasingly using information online to support their decision-making about what financial products to use and the most appropriate organisation to seek investment from. A 2018 study by the BBB revealed that in just one year there was a 4% increase in the number of business owners using the internet for this purpose indicating that entrepreneurs are diversifying their sources of information. This suggests that there could be an opportunity for the Bank and its public sector partners to capitalise on increased reliance on online resources to identify and compare financial products.

Despite more entrepreneurs researching their options, direct interaction with banks remains the most popular method for business owners to find out about securing investment in their firm with the vast majority going to their existing bank.[20] Further research into this by the BBB has revealed that 41% of firms that obtained funding chose their provider on the basis that they had an existing relationship with them.[21] Loan application rejections have a significant influence on borrower discouragement with almost half of those who aren't offered the full amount of credit sought either giving up or putting plans on hold.[22] In fact just 13% of SMEs that had not been offered the full amount of funding they sought indicated that they had spoken to another provider.[23] These figures suggest that a policy intervention is necessary to reduce borrower discouragement among those entrepreneurs who have not been offered all of the money that they applied for to encourage them to consider other providers or forms of finance

c. **positively contribute to market intelligence and formation of evidence-based decisions by improving understanding in the market place of access to finance issues, especially arising from information asymmetries on some firms, for example, those companies that contribute to reducing socioeconomic disadvantage, including establishing and publicising the accessibility of those categories of firms to lending by financial institutions.**

   Please refer to conclusions on improving access to finance for firms that contribute to poverty reduction.

27. The benefits that could be derived through success in reducing these barriers and ensuring that socioeconomically disadvantaged entrepreneurs can access the credit that they require are potentially significant not just for individual entrepreneurs but for poverty in Scotland more broadly. Evidence has shown that a key driver of entrepreneurialism in disadvantaged communities is knowing someone who has started a successful business. Increasing the number of companies established by individuals from poorer communities through improved access to credit could prompt a growth in entrepreneurship from the socioeconomically disadvantaged.

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[20] British Business Bank, 2018 Business Finance Survey: SMEs p. 34
[21] British Business Bank, 2018 Business Finance Survey: SMEs, p. 37
[22] British Business Bank, 2018 Business Finance Survey: SMEs, p. 45
[23] British Business Bank, 2018 Business Finance Survey: SMEs, p. 45

IMPROVING ACCESS TO FINANCE FOR FIRMS WITH CHARACTERISTICS THAT CONTRIBUTE TO POVERTY REDUCTION

INTRODUCTION

28. Alongside direct investment in those who are socioeconomically disadvantaged, the FSDA Panel also identified a series of indirect methods through which the Bank could contribute to the Scottish Government's goal of reducing inequalities of outcome arising from socioeconomic disadvantage. In particular, the Panel drew attention to the fact that certain types of SME, by virtue of specific characteristics, can make a significant contribution to reducing inequalities of outcome arising from socioeconomic disadvantage. As such, the Panel proposed that consideration be given to how the Bank can invest in and foster businesses with these characteristics.

29. SMEs, the target market for the Bank's investments, constitute the backbone of the Scottish economy where a substantial proportion of the nation's working age population are employed. The Supporting Analysis published alongside the Implementation Plan observes that 55% of people employed in the private sector work for an SME, which represents a total of 1.2 million people.[24] The Bank's primary role of investing directly in SMEs and of leveraging in private sector capital will fuel a key driver of job growth in the Scottish economy creating job opportunities that are a vital route out of poverty. Further investigation into the Panel's observations, revealed that where a firm is located and the company model it adopts can further enhance the capacity of that business to alleviate poverty.

BARRIERS TO ACCESSING FINANCE FOR MICROBUSINESSES

30. Microbusinesses are the smallest class of firm operating in the UK and are generally understood to be those companies with 10 employees or fewer. They are a hugely influential and important part of the economy responsible for employing many of those who work in the private sector. The prevalence of microbusinesses mean that they make a significant contribution to job growth in the Scottish economy meaning that they have considerable capacity to reduce socioeconomic disadvantage. Microbusinesses also possess other characteristics that contribute to alleviating poverty that are worth drawing attention to in the context of this FSDA. As well as creating a large number of jobs, they are more likely to employ local people who may be excluded from or unable to access other sectors of the labour market while proximity of staff to business owners also contributes to improved workplace conditions and employment practices. These companies also promote the flow of financial resources into local communities as well as being more receptive to the needs of these communities. Finally, microbusinesses, provide role models and support for future entrepreneurs.

[24] 'Scottish National Investment Bank Supporting Analysis', Scottish Government, 2018, p. 7

Firm-Level Characteristics

31. Evidence shows, however, that microbusinesses experience a range of challenges in accessing credit either for working capital or to fund their growth aspirations. Microbusinesses tend to have lower capital intensity meaning that the size of loan they usually seek is smaller. The LSBS reveals that the size of loan sought has a considerable impact on the ability of businesses to secure the capital they require from banks and financial institutions. In fact it clearly demonstrates that the smaller the business the less likely it is to secure a loan, a likelihood that drops sharply for microbusinesses and companies with no employees:
    a. **Success in securing full value of loan sought from bank/building society according to business size:** 74% of medium-sized enterprises and 71% of small businesses that sought a bank loan were successful in securing all of the money they asked for compared to 58% for microbusinesses and 47% for companies with no employees.[25]
    b. **Rejection rates for loan applications to bank/building society according to business size:** 24% of microbusinesses and 44% of companies without employees were rejected for a business loan from a bank/building society. By comparison, just 12% of small businesses and 10% of medium-sized enterprises were rejected.
    c. **Outcome of application for credit card according to business size:** 88% of medium-sized enterprises and 83% of small businesses were successful in securing a credit compared to 71% of microbusinesses. In Scotland, 46% of companies without employees who applied for a credit card were successful.
    d. **Outcome of application for Government or local authority grant or scheme according to business size:** 76% of microbusinesses and 73% of companies without employees secured some or all of the funding they applied for from central or local government. This is more closely aligned with the experience of small businesses and medium-sized enterprises whose success rate was 80% and 64% respectively in securing some or all of the funding they sought.[26]

32. The implications from the LSBS are unequivocal, the smaller the business the harder it is to secure traditional forms of debt finance from a private lender. Additionally, the LSBS reveals that the public sector plays an important role in redressing the flow of finance towards larger businesses. In seeking to understand why the size of a business has such a marked impact on its ability to secure external funding, academics have tended to focus on banks' target rate of return and the costs associated with assuring and managing investments.

33. These factors render investing smaller sums of money less attractive to banks and financial institutions placing an automatic constraint on socioeconomically disadvantaged entrepreneurs seeking finance through traditional routes. In addition, size also has an impact on the capacity of companies to convey creditworthiness. Small businesses do not have audited financial statements or

[25] UK Government, '2018 Longitudinal Small Business Survey', accessed from https://www.gov.uk/government/statistics/small-business-survey-2018-businesses-with-employees
[26] UK Government, '2018 Longitudinal Small Business Survey'

publicly available contracts with staff and suppliers which means they lack the 'hard' information that banks increasingly require to inform their decision-making on whether to approve a loan application.[27]

Borrower Discouragement

34. Studies have shown that microbusinesses are not only disadvantaged by the activities of financial markets and the practices of individual institutions but also experience substantial demand-side barriers to securing external investment. Borrower discouragement has become an increasingly significant and pressing area of research for economists in recent years both because of the huge number of businesses that are deterred from seeking the finance that they require from the most appropriate source and the damaging impact that failure to seek finance can have on that business. Studies have shown that there may in fact be twice as many discouraged borrowers in the UK, defined as creditworthy businesses that decide not to seek funding when they have a legitimate requirement to do so, than which actually have their applications rejected. Rejections for applications may be the tip of the iceberg with regard to firms not securing the finance they require to invest and grow.[28]

35. Research indicates that microbusinesses are particularly prone to borrower discouragement in comparison to SMEs. A survey into trust in financial institutions in the UK revealed that the smaller the enterprise the less trust they had in banks, a factor which has significant implications for whether a business decides to seek credit.[29] Knowledge about financial products available appears to be a significant reason for borrower discouragement and one that is particularly prevalent among microbusinesses. 18% of microbusinesses surveyed for the 2018 LSBS that reported being discouraged from applying for finance highlighted not knowing where to find appropriate financial products as a reason why they didn't seek capital. In fact 24% of firms in Scotland listed not knowing where to find appropriate financial products as a reason why they didn't apply for credit, significantly more than in England and Wales hinting at a wider problem.[30]

Rural Microbusinesses

36. Although more often associated with urban areas, poverty is also a reality for many who reside in Scotland's rural communities. 14% of people in rural areas of Scotland (170,000) live in relative poverty after housing costs.[31] Fewer job opportunities coupled with high living costs and reduced accessibility are drivers of disadvantage that are often hidden due to associations between the countryside and wealth.

[27] R. Brown and N. Lee, 'The Theory and Practice of Financial Instruments for Small and Medium-sized Enterprises', *Organisation for Economic Co-operation and Development (OECD),* 2017, p. 11
[28] Brown and Lee, 'The Theory and Practice of Loan Financial Instruments for Small and Medium-sized Enterprises', p. 28
[29] R. Brown and N. Lee, 'Reluctant Borrowers? Examining the demand and supply of finance for high growth SMEs in the UK', *Institute of Chartered Accountants Scotland (ICAS)*, 2017, P. 22.
[30] UK Government, '2018 Longitudinal Small Business Survey'
[31] UK Government Department of Work and Pensions, *Households Below Average Income*

37. Microbusinesses are particularly important to the rural economy due to the fact that 9 in every 10 rural firms are microbusinesses, employing 68% of the workforce in remote rural and 54% in accessible rural Scotland. They also experience distinct challenges in accessing credit compared to their counterparts in urban areas and so it is worth considering some of these challenges separately. The implications of these firms failing to secure sufficient capital are often profound and its impact is rarely confined to the short term. Firms unable to access the finance they require exhibit lower growth, less productivity and substantially less innovation when compared to those who have secured the requisite level of capital. To reduce poverty it is vital that rural businesses have access to the credit that they require to achieve their growth ambitions to increase the proliferation of high quality jobs.

38. Research has demonstrated that peripherally located businesses experience distinct challenges in accessing finance due to 'the liability of distance' making it more difficult for rural firms to offset the impact of information asymmetries. In the first instance, assets, such as property, tend to be significantly cheaper in rural areas which means that business-owners have lower levels of collateral against which to secure loans. The ability of rural business owners to overcome information asymmetries has also been impacted by the retreat of banks from high streets in Scotland making it harder for them to establish a relationship with potential investors. Bank closures were highlighted as a particular issue in responses to the Scottish National Investment Bank Consultation, with respondents highlighting the negative impact that they have on peripherally located businesses. The growing prevalence of Fintech and the premium it places on hard information with which to influence lending decisions could further exacerbate these challenges for rural businesses. It is important that rural firms benefit from the improved access to financial products that Fintech offers the wider business community.[32]

39. Economists have stressed the importance of the entrepreneurial ecosystem in directing business owners about where to seek finance. These ecosystems are generally underdeveloped in peripheral regions meaning that understanding or awareness of the types of financial products available is lower than it is in urban areas.[33] Evidence has identified that microbusinesses are more likely to be discouraged from borrowing than larger firms.[34] The impact of borrower discouragement is significant exerting a considerable impact on the productivity, innovation and growth rate across the lifetime of those that don't seek investment when they need it.

[32] Lee and Brown, 'Innovation, SMEs and the Liability of Distance', p. 234
[33] Lee and Brown, 'Innovation, SMEs and the Liability of Distance', P. 238
[34] R. Brown, J. Linares-Zegarra and J. Wilson, 'An Empirical Examination of Discouraged Borrowers in the UK', *Enterprise Research Centre*, Paper 69, 2018, p. 14

Conclusions

40. It is clear therefore that a significant opportunity exists to reduce socioeconomic disadvantage by supporting the establishment and expansion of microbusinesses in Scotland due to inherent characteristics of these firms which contribute to reducing socioeconomic disadvantage. Evidence shows that accessing credit to fund growth and for cash flow purposes is a challenge for microbusinesses, substantially more so than it is for SMEs, stymieing their positive impacts on reducing socioeconomic disadvantage. These challenges appear to be particularly acute for microbusinesses in rural areas.

BARRIERS TO FINANCE FOR EMPLOYEE-OWNED BUSINESSES

41. Microbusinesses are not alone in possessing inherent characteristics that contribute to alleviating poverty. Firms that use specific company models have also been shown to have specific traits that can reduce socioeconomic disadvantage. This incorporates a wide range of company models including co-operatives, b-corps, social enterprises or community interest companies which, in different ways, distribute the wealth they generate. For the purposes of this FSDA, this section looks specifically at employee-owned businesses as an exemplar of an atypical company model that contributes directly to improving the socioeconomic status of its staff.

42. Employee-owned businesses utilise a non-pyramidal company model by sharing ownership of the company across those who work for the firm. The effect of this is to democratise the workplace generating higher wage growth, enhancing job security, improving workplace wellbeing and embedding employee engagement. In addition, studies have shown that employee-owned businesses exhibit higher job growth than SMEs that utilise pyramidal company models. Employee-owned businesses are also rooted in local communities creating stable employers that are at considerably reduced risk of acquisition and relocation or closure by competitors,[35] a process to which SMEs in Scotland have been particularly vulnerable in recent years and which can be particularly damaging for local economies especially in rural areas.[36] The power of employee-ownership has already been recognised by the Scottish Government through its *Scotland for EO* policy which aims to increase the number of employee-owned businesses in Scotland to 500 by 2030.

43. Employee-ownership has become an increasingly popular business model in recent years in Scotland and there are now estimated to be more than 100 employee-owned businesses operating in Scotland. The value of employee-ownership to both the company and its staff has become increasingly apparent in recent years which has precipitated the development of a supportive ecosystem to assist interested companies explore the transition to becoming employee-owned. Despite the existence of this network, challenges remain for

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[35] R. McQuaid, R. Brown, J. Summers and S. Mawson, ‘Employee-owned Businesses – Access to Funding Final Report’, *University of Stirling* and *University of St Andrews*, 2014, p. 14

[36] C. Mason, R. Brown, M. Hart and M. Anyadike-Danes. ‘High Growth Firms, Jobs and Peripheral Regions: The Case of Scotland’, *Cambridge Journal of Regions, Economy and Society*, Vol. 8, 2015, p. 353.

those SMEs that want to become employee-owned particularly in relation to raising the external capital required to fund an employee buy-out (EBO). Even if they don't require the full value of the business upfront, owners who wish to exit their business will typically seek a substantial initial payment upon exit which many see as either their pension pot or working capital to fund their next venture. Employees often lack the means to come up with this initial capital which can be a barrier on companies becoming employee-owned unless they are able to secure external funding in order to facilitate the EBO.[37]

44. There are, however, a range of challenges that business wishing to pursue an employee-owned company model experience when wishing to access external capital in order to fund an EBO. Given the role played by employee-owned businesses in supporting the development of a wellbeing economy, responses to the Committee's Call for Evidence on the Bill have proposed that consideration be given to how the Bank can support the proliferation of employee-owned businesses.

Supply-side Barriers

45. Many of these barriers are broadly similar to those experienced by microbusinesses not least the value of loans sought in order to fund the buy-out which do not generally do not deliver the rate of return thresholds sought by many banks and financial institutions. A qualitative survey exploring access to finance for employee-owned businesses revealed the attitudes of banks towards funding EBOs and found scepticism about whether investing in employee-owned businesses would deliver the rate of return they required.[38] This survey also identified that transition to an employee-owned business meant that the company would assume a different credit risk and that banks would be unable to take past performance into consideration when making a decision on whether to lend.[39] To offset this credit risk, financial institutions typically seek to extract significant personal guarantees from directors as collateral against which to secure their investment which is often too great a level of risk for that director.[40]

Demand-side Barriers

46. Demand-side barriers also explain why employee-owned businesses are disadvantaged in accessing finance. A survey conducted with established employee-owned businesses and those considering the transition to becoming employee-owned revealed that many are suspicious of using loans and, particularly, equity funding to finance an EBO due to a fear of rent-seeking behaviours and the impact of outside interference. Although they are gaining in popularity, misinformation about employee-owned businesses and the process for establishing them is pervasive meaning that many entrepreneurs fail to consider this as an exit route due to a lack of awareness that it is an option or misconceptions about it implications.

[37] McQuaid et al, 'Employee-Owned Businesses – Access to Finance', p. 8
[38] McQuaid et al, 'Employee-Owned Businesses – Access to Finance', p. 26
[39] McQuaid et al, 'Employee-Owned Businesses – Access to Finance', p. 26
[40] McQuaid et al, 'Employee-Owned Businesses – Access to Finance', p. 5

Conclusions

47. The experience of employee-owned businesses shows that private financial institutions are less comfortable investing in those businesses that utilise company models which differ from those operated by firms that they are more used to giving credit to. Much like with microbusinesses, however, there are also appear to be demand-side obstacles that prevent these companies coming forward for investment when they have a legitimate need to do so. Both these demand and supply-side barriers need to be addressed if the wealth distribution models of these companies is to have a significant impact on reducing socioeconomic disadvantage in Scotland.

ADDRESSING THESE BARRIERS

48. It is a by-product of the credit rationing processes adopted by banks and building societies that organisations such as microbusinesses and company which utilise atypical company models that contribute to reducing disadvantage are also disadvantaged in their efforts to and discouraged from securing credit. As part of the obligations placed upon it by the Fairer Scotland Duty the Bank should also give consideration to how it can work with partners across the public sector and beyond to help improve access to credit for these organisations. The findings of this FSDA also demonstrate that the following conclusions are also relevant to the Bank in respect of improving access to finance for those businesses that contribute to alleviating poverty. The Bank, once established should:

    a. **consider how it can contribute to an investment landscape which actively removes barriers to accessing finance for microbusinesses and organisations with inherent characteristics that contribute to reducing poverty. The Bank should consider the development of financial products that are tailored to the needs of these businesses where they are not already available through other bodies. Where necessary the Bank should conduct or commission robust and transparent analysis of the gap in provision of credit for these businesses to inform its role.**

       As is the case in respect of access to finance for socioeconomically disadvantaged entrepreneurs, the LSBS is unable to shed light on the number of organisations with inherent characteristics that contribute to reducing poverty who experience barriers in securing credit despite representing an investible proposition. This FSDA therefore suggests that a full analysis is conducted into the gap in provision of capital for these businesses to inform the steps that should be taken to mitigate this gap.

    b. **support relevant partners across the public sector to improve awareness among entrepreneurs about the types of financial products available to them when seeking to start or scale up their business, and develop core skills required to make their business a success. In addition, the Bank may wish to communicate its suite of financial products to other lenders so that they are fully aware of the finance**

available and can refer entrepreneurs and businesses seeking such support, where appropriate.

Please refer to conclusions on improving access to finance for socioeconomically disadvantaged entrepreneurs

c. **positively contribute to market intelligence and formation of evidence-based decisions by improving understanding in the market place of access to finance issues, especially arising from information asymmetries on some firms, for example those companies that contribute to reducing socioeconomic disadvantage, including establishing and publicising the accessibility of those categories of firms to lending by financial institutions.**

The Bank's ultimate aim is to resolve market failures by encouraging banks and financial institutions to invest in areas where viable businesses are being prevented from scaling up due to a lack of sufficient capital to support their growth aspirations. An important part of achieving this will be the role that the Bank plays in de-risking investment in specific types of SME by providing private investors with the information that they require to recognise the opportunities rather than the risks of investing in specific types of business. The Bank's role as a market intelligence actor therefore holds the potential to have an impact well in excess of its investment activity. The BBB already has a mandate to collate and publish information about the SME market at the UK level but having an actor capable of analysing information and extrapolating trends specific to the Scottish economy could give banks and financial institutions the confidence to invest outside of traditional lending patterns. In addition, consideration should be given to other areas where information asymmetries exacerbate inequalities of outcome arising from socioeconomic deprivation where the Bank, in its role as a market intelligence actor can address these.

INTRODUCING LOAN COVENANTS

INTRODUCTION

49. The majority of organisations to which the Bank lends money will not have an inherent impact on reducing socioeconomic disadvantage in the way that the evidence demonstrates rural SMEs and employee-owned businesses do. As identified by the Fairer Scotland Duty Assessment Panel, however, its role as an investor gives the Bank a unique opportunity to influence the behaviour of those organisations to which it lends money incentivising practises that contribute to reducing inequalities of outcome arising from socioeconomic disadvantage. The primary mechanism through which the Bank can seek to influence the behaviour of those businesses that it lends to is through attaching conditions to its investments designed to encourage the introduction of practices that reduce disadvantage and avoid engaging in those that entrench it.

50. The idea of attaching conditions to investments is not new. Loan covenants are used frequently by banks and other financial institutions as a means of managing the behaviour of businesses that they lend money to. In effect, loan covenants are conditions attached to commercial loans that either require the borrower to fulfill certain requirements, forbid them from undertaking certain actions or restricts specific activities to circumstances when other conditions are met. Attaching conditions to loans issued by the Bank would therefore be in keeping with methods widely used by other commercial lenders.

51. Despite the significant potential in utilising loan covenants to incentivise businesses to deliver social value, the Fairer Scotland Duty Assessment Panel and other stakeholders were of the view that the Bank should avoid taking a one-size fits all approach to introducing these and that it should not be necessary for all companies to comply with these conditions before they are considered eligible for investment as long as there was a clear roadmap towards implementation of Fair Work principles within that business. There are significant variations in the business community across Scotland and the sort of conditions that are appropriate for a certain type of organisation may not be suitable for another, the Bank's approach to introducing any type of loan covenant must reflect this. Moreover, research has demonstrated that loan covenants can have unintended consequences that impact negatively on businesses and their employees. The rationale for the Bank adopting a nuanced approach to introducing loan covenants is explored in more detail below.

FAIR WORK FIRST

52. Over the past ten years the UK has seen a spike in instances of in work poverty, that is to say the number of individuals or households that have employment but are classed as being socioeconomically disadvantaged has risen sharply since 2008.[41] The Final Report of the IPPR Commission on Economic Justice highlights that stagnating wage growth, insecure employment and falling

[41] IPPR Commission on Economic Justice, 'Prosperity and Justice: A Plan for the New Economy', p. 12

workplace participation have collectively contributed to this rising tide of in work poverty across the UK.[42] The Scottish Government has introduced a variety of policy measures aimed at counteracting the proliferation of workplace practices which mean that work is no longer a reliable route out of poverty. Foremost among these has been the introduction of Fair Work First, a policy initiative designed to encourage and embed the following within Scottish employers:

- investment in skills and training;
- no exploitative zero hours contracts;
- action on gender pay;
- genuine workforce engagement, including with trade unions; and
- payment of the Real Living Wage.

53. In October 2018, the First Minister extended the scope of Fair Work First to more of the Scottish Government's contracts and support grants. This is in addition to existing announcements by the Scottish Government that it will demonstrate leadership in adopting Fair Work principles in its role as an employer, a commitment that encompasses the Bank. Fair Work First is in its infancy as a policy and so there is limited data available to draw any conclusions regarding whether it has been successful in alleviating socioeconomic disadvantage but research suggests that it has significant scope to reduce the prevalence of in work poverty in Scotland. A recent report by IPPR Scotland, for example, highlighted the potential of workplace representation in boosting productivity and wage growth.[43]

54. Given that those businesses successful in applying for funding from the Bank will be in receipt of substantial sums of public money, it is not unreasonable to request that they have practices and policies in place which support the delivery of social value. Indeed elements of Fair Work First have already been attached to RSA Grants awarded by the enterprise agencies.

55. In addition, the Building Scotland Fund (BSF), a precursor to the Bank, is considering collecting data on the prevalence of Fair Work principles within the businesses that it invests in. Responses to the Committee's Call for Evidence on the Bill have highlighted strong support among stakeholders for attaching Fair Work conditions to investments made by the Bank. Further analysis is required, however, regarding the introduction of Fair Work First to commercial investments as distinct from procurement contracts and support grants and the data collected by the BSF will be important in informing this approach.

Adopt a tailored approach

56. Studies have shown that borrower discouragement can vary significant between different countries. In the US, for example, evidence suggests that 30% of those businesses that don't apply for capital when they have a requirement to do so

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[42] IPPR Commission on Economic Justice, 'Prosperity and Justice: A Plan for the New Economy', p. 12

[43] Rachel Statham and Russell Gunson, *'How Productivity Could Delver Inclusive Growth in Scotland',* IPPR Scotland, June 2019, p. 39

are creditworthy. The equivalent figure for the UK is 50% demonstrating that there are localised factors at play which exert a significant influence on levels of borrower discouragement.[44] Of these localised factors, research indicates that loan covenants are a significant reason for borrower discouragement. A survey exploring reasons for borrower discouragement among high growth firms in the UK found that 20% of those businesses that responded felt that the nature of loan covenants had a strong influence on their decision about whether to seek finance. Significantly this figured increased the smaller the firm with microbusinesses particularly reticent about the impact of loan covenants.[45]

57. It is therefore important that the Bank adopts a tailored approach to introducing loan covenants aimed at encouraging Fair Work First within the firms that it lends to. More work is necessary to determine what a tailored approach means in practice and this should be informed by detailed discussions with businesses and trade unions but initial research suggests that the Bank should utilise its ongoing relationship with companies to encourage them to adopt Fair Work First. This will require the Bank to have the appropriate corporate and staff structures in place to monitor implementation of Fair Work First across the organisations that it invests in and will require staff who have the appropriate skills and are incentivised to build a strong rapport with business owners.

58. Work will also be required with those organisations that are commissioned to administer funds on behalf of the Bank to understand how Fair Work First can be implemented sustainably. The Bank may also be able to utilise incentives to encourage businesses towards the adoption of Fair Work practices examples of which can already be found in the financial sector.

Training and upskilling of staff

59. Each of the Fair Work principles adopted by the Scottish Government have a distinct and important role to play in addressing the growth of in work poverty. Skills and training is perhaps the most important yet most easily neglected of the five principles. Implementing the Real Living Wage within businesses, for example, will act to lift staff members out of poverty but giving them skills will enhance their employability and earnings potential giving them the opportunity to increase their income exponentially. Studies have shown that there is both a supply and demand-side skills problem in the UK which means that there is not only a skills shortage in the UK but that those skills which do exist are, in many cases, not being utilised effectively by firms.[46] A recent report by IPPR Scotland highlighted the need for increased expenditure on in work training with a particular focus on upskilling those working in low paid sectors of the economy.[47]

60. Research has found that lower levels of human and social capital (fewer qualifications, less experience in the labour market and less developed professional networks) can also lead to lower incomes, increased working hours

[44] Brown, Linares-Zegarra and Wilson, 'An Empirical Examination of Discouraged Borrowers', p. 6
[45] Brown and Lee, 'Reluctant Borrowers? Examining the Demand and Supply of Finance for High Growth SMEs in the UK', pp. 22 – 23.
[46] IPPR Commission on Economic Justice, 'Prosperity and Justice', p. 49
[47] Staham and Gunson, *'How Productivity Could Deliver Inclusive Growth,* p. 40

and less stable employment among those who are self-employed. The academic literature has termed this phenomenon 'self-exploitation'.[48] Instances of self-exploitation are particularly prevalent among those groups who experience disadvantages in the labour market due to lower levels of human and social capital. Self-exploitation can act to entrench inequalities of outcome not only by further depressing the incomes of those who are disadvantaged but also by damaging both physical and mental wellbeing.[49]

61. In addition, where individuals have utilised external capital to establish a business which then becomes unsustainable the chances of that debt being unserviceable are even higher. This FSDA therefore draws specific attention to the skills development and training dimension of the Fair Work principles as a means of supporting people to lift themselves out of poverty.

Focus on the benefits of introducing Fair Work Principles

62. Studies have shown that Fair Work is not only good for employees, it is also good for employers demonstrating that businesses with a motivated, engaged and appropriately skilled workforce enjoy substantial benefits.[50] As the Scottish Government's Fair Work Action Plan highlights, those businesses that have embedded Fair Work in their policies and practices are more likely to benefit from sustainable growth.[51] In encouraging the adoption of Fair Work principles within the firms that it invests in the Bank should highlight the benefits that businesses typically enjoy by adopting these. This could involve utilising the experience of other companies that have introduced Fair Work policies in the Bank's marketing strategy to ensure that loan covenants do not discourage borrowers.

REQUIREMENT TO BE PART OF A BUSINESS ASSOCIATION

63. The IPPR Commission on Economic Justice Report identified three distinct and important roles for business associations in creating a cohesive and organised economy. The report states the following:

> *" They [business associations] represent the interests of their members to the state, enabling sectors to make coherent requests of government for particular policy interventions. They act as mechanisms for the diffusion of innovation from one business to the other through the exchange of good practice and by creating greater fluidity between firms. And by building relationships, they create direct commercial opportunities for business-to-business commerce, and as a gateway for international trade"*[52]

64. Although the relevance between business association membership and reducing inequalities of outcome arising from socioeconomic disadvantage may not be

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[48] Atherton, Wu and Wu, 'Self-exploitation or successful entrepreneurship?' P. 1
[49] Atherton, Wu and Wu, 'Self-exploitation or successful entrepreneurship?' P. 1
[50] Working Together Review: Progressive Workplace Policies in Scotland, *Scottish Government*, 2014, P. 10
[51] Scottish Government, Fair Work Action Plan,
[52] IPPR Commission on Economic Justice, 'Prosperity and Justice', p. 72

immediately apparent, economists have established a clear link between innovation and wage growth via productivity gains precipitated by firms that engage in innovation. As highlighted by the IPPR Scotland Report entitled 'How Productivity could Deliver Inclusive Growth in Scotland', productivity growth is low in Scotland and measures to improve it could lead to significant improvements in wage growth, particularly in low paid sectors of the economy.[53]

65. Membership of business associations in the UK is particularly low which means that SMEs, and the wider economy, do not enjoy these benefits to the same extent as firms in other countries. In Japan, 24% of firms are members of a business association with this number rising to 50% in the USA, the comparative figure in the UK is just 3.5%.[54] **The Bank should therefore give consideration to whether it should encourage those businesses that it invests to join a business association or to find other networking opportunities that will enable them to learn and share best practice with those who have similar growth, innovation and business practice ambitions.**

ADOPTING COMMUNITY BENEFIT CLAUSES

66. The concept of Community Benefit Clauses have grown in popularity in recent years particularly within the Scottish Government who have introduced these clauses into public procurement contracts over £4 million. The Procurement Reform (Scotland) Act 2014 establishes a national legislative framework for public procurement that supports Scotland's economic growth by delivering social and environmental benefits, supporting innovation and promoting public procurement processes and systems which are transparent, streamlined, standardised, proportionate, fair and business friendly. **The Bank may also wish to consider how it can introduce community benefit clauses as loan covenants to high value investments aimed at reducing inequalities of outcome arising from socioeconomic disadvantage**.

67. This could include encouraging organisations who receive large sums of money from the Bank to review their procurement practices to ensure that they incorporate more Scottish and locally-based companies into their supply chain where it is possible for them to do so. This also utilises Community Wealth Building principles adopted in Preston and mentioned in responses to the Committee's Call for Evidence on the Bill whereby the wealth generated by anchor institutions are retained within local communities.

[53] Staham and Gunson, *'How Productivity Could Deliver Inclusive Growth,* p. 40
[54] IPPR Commission on Economic Justice, 'Prosperity and Justice', p. 72

BUILDING POVERTY REDUCTION INTO THE BANK'S GOVERNANCE

INTRODUCTION

68. The ambition for the Bank as set out in the Implementation Plan is for it to be an institution that is a new and distinct actor in Scotland's economy, a publicly owned commercial lender geared towards delivering both social and financial returns. Although the concept of social value is not specifically defined within the Implementation Plan, the Bank's role as a financial institution and the Scottish Government's commitment to delivering inclusive growth as part of its Economic Strategy both suggest that reducing socioeconomic disadvantage is a key facet of delivering social value.[55] The Implementation Plan contains proposals designed to differentiate the Bank from private lenders by supporting it to achieve social value through its investments. The following section will consider these proposals and assess how these can be tailored towards reducing inequalities of outcome arising from socioeconomic disadvantage.

OBJECTS OF THE BANK

69. Benny Higgin's Foreword to the Implementation Plan's states that the Bank should have '…the twin objectives of making a return in excess of the cost of capital at portfolio level and by achieving inclusive and social economic benefits.'[56] References to inclusive growth are made numerous times throughout the Implementation Plan itself emphasising that it should be an important feature of the Bank's investment activity. The Bill, introduced to the Scottish Parliament on 28 February 2019 reflects the Implementation Plan and its aspiration to ensure that delivering inclusive growth is embedded in the foundations of the Bank. The Bill places a requirement on the Articles of Association to contain an ancillary object which gives the Bank the function of investing in inclusive economic growth.[57]

70. Evidence gathered by the Committee during their scrutiny of the Bill highlighted some concerns around the nature of the Bank's objects. A number of those stakeholders who gave evidence to the Committee suggested that the objects were not explicit enough in orientating the Bank towards delivering social value due to ambiguity around the meaning of inclusive growth. Stakeholders felt that without clarity on the meaning of inclusive growth within the legislation the Bank would prioritise financial returns.

71. It has become clear through the evidence provided to the Committee that inclusive growth has a variety of interpretations not all of which necessarily are focused on reducing the exclusion of those socioeconomic disadvantage. This suggests that there is a need to provide clarity within the legislation to ensure that the aspirations and intentions of the Implementation Plan are reflected in the activities of the Bank as enshrined within the legislation that underpins it.

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[55] 'Scotland's Economic Strategy' *Scottish Government*, 2015, p. 13
[56] Scottish National Investment Bank Implementation Plan., p. iv
[57] Scottish National Investment Bank Bill, 2018, Scottish Government

Moreover, incorporating a role for the Bank in reducing socioeconomic disadvantage through the Bill will ensure that it supports delivery of the National Performance Framework. **This FSDA therefore recommends that the Scottish Government review the ancillary objects contained within the Bill to best align the Bank with the purposes of the Fairer Scotland Duty, utilising its position as a 'cornerstone in Scotland's economic architecture' to shape an economy that is diverse, democratic and which enhances societal wellbeing.**

MEASURING THE BANK'S PERFORMANCE

72. The Implementation Plan recommended that the Bank utilise a balanced scorecard approach to reporting on its performance.[58] This recommendation has been strongly supported by those who responded to the Committee's Call for Evidence on the Bill many of whom highlighted that adopting a balanced scorecard approach to reporting on the performance of investments would encourage consideration of social and environmental returns within the Bank's decision-making. The Committee itself has also lent its support to the adoption of a balanced scorecard approach within its Stage 1 Report on the Bill.[59]

73. Broadly, a Balanced Scorecard is understood to be a performance metric used in strategic management to identify how an organisation or a particular function of that organisation is performing across a range of different outcomes. Collecting this data will then give that organisation the information it requires to embed continuous improvements in how it operates to ensure that it delivers across the broad range of desired outcomes. Within the context of the Bank specifically, the Implementation Plan states that financial returns from investments should be considered alongside '…economic impact over time, including social, environmental and ethical returns.'[60] That is to say that delivery against the set rate of return should not constitute the sole means by which the performance of the Bank should be judged.

74. The Scottish Government has committed to all 21 recommendations contained within the Implementation Plan and therefore a balanced scorecard approach will be adopted as a means of measuring the Bank's performance. Given the Scottish Government's commitment to addressing inequality and the significant impact that socioeconomic disadvantage has on the lives of those who experience it, there is a strong case to be made for ensuring that the Bank's effectiveness in addressing poverty is one of the outcomes included in the balanced scorecard.

75. **It is therefore recommended that the Bank develop a series of metrics against which to assess the contribution of the Bank towards reducing socioeconomic disadvantage in Scotland. These metrics should seek to assess the performance of the Bank in this regard across the full range of its activities to develop a holistic picture its contribution. This will be in**

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[58] 'Scottish National Investment Bank: Implementation Plan', p. xii
[59] Economy, Energy and Fair Work Committee, 'Scottish National Investment Bank Bill Stage 1 Report', *Scottish Parliament*, 2019, p. 15
[60] 'Scottish National Investment Bank: Implementation Plan', p. xii

addition to metrics covering other social, environmental and economic impacts as well as financial returns. These metrics should be developed taking into account the views of the Fairer Scotland Duty Assessment Panel to support the Scottish Government in devising measures that provide clear insight into what impact the Bank is having on reducing socioeconomic disadvantage in Scotland.

76. It is also important to recognise that the experience of poverty is not static but rather changes over time, a fact that must be recognised within the Bank's governance arrangements. **This FSDA recommends that the voice of those with lived experience of poverty is represented in membership of the Advisory Group so that Scottish Ministers have access to expert advice on the contribution of the Bank in helping to reduce socioeconomic disadvantage and ensuring that the Bank evolves its activities in response to the changing characteristics of poverty over time**. This Assessment does, however, recognise that the Advisory Group must reflect the views of a broad cross section of Scottish society within a limited membership and recognises that decisions about who sits on the Advisory Group must be taken within this context.

Adopting a Mission-Orientated Approach

77. Alongside score-carding, the Scottish Government has also committed to adopting a mission-orientated approach as recommended by the Implementation Plan.[61] A mission-orientated approach will guide the activity of the Bank by directing its investments towards addressing key societal challenges as set by Scottish Ministers. Work is ongoing, in consultation with stakeholders, to identify and develop missions for the Bank that will give it a key role in addressing societal challenges.

78. Due to the importance of these missions in shaping the Bank and directing its activity, a further iteration of this FSDA will be published once these missions have been set to ensure that delivery against them also contributes to show how evidence was considered to show how evidence was considered to ensure that delivery against them will reduce inequalities of outcome arising from socioeconomic disadvantaged. The Fairer Scotland Duty Assessment Panel has already supported the Scottish Government in considering how this Duty can be applied to the development of Missions for the Bank and work around developing these continues.

[61] 'Scottish National Investment Bank: Implementation Plan', p. xii

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Any enquiries regarding this publication should be sent to us at
The Scottish Government
St Andrew's House
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EH1 3DG

ISBN: 978-1-83960-149-1 (web only)

Published by The Scottish Government, September 2019

Produced for The Scottish Government by APS Group Scotland, 21 Tennant Street, Edinburgh EH6 5NA
PPDAS630690 (09/19)