Financing Scotland's Recovery

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Foreword

A general theme of the report by the Advisory Group on Economic Recovery (AGER) was the desire for Scottish Government (SG) to use its convening power as well as its intervening power on policy and financial matters. In particular, SG was urged to recognise that – as 80% of jobs in Scotland are in the private sector – a strong supportive, relationship with business is essential. Furthermore, since firms with less than 50 people account for over 98% of private sector businesses, the role of small business is crucial. A specific recommendation by AGER was that SG should convene a discussion with banks and other private sector investors to understand better how we can facilitate financing economic recovery.

I have chaired a small group of such banks, investors and CBI Scotland over the last couple of months. We have had a series of short meetings and syndicated work in parallel. The engagement from those involved has been open, transparent, and focused. We also commissioned extensive focus groups with businesses across the country, facilitated by CBI Scotland and the Federation of Small Businesses. This report sets out the principal conclusions. It is hoped that it will serve to set out the starting point, form the basis of a plan of advocacy, and provide a list of recommended actions that will propel the financing of economic recovery.

Since the beginning of the pandemic, the UK Government has made a number of interventions to support businesses and households. These steps have been essential, but we must also recognise the context and likely consequences. Given that so much of the economy experienced an emergency halt in March, the nature of financial interventions have been necessarily blunt and broad. The varying and enduring nature of the restrictions has led inexorably to the extension of such interventions.

The banks, in particular, have played an important role acting in concert with UK Government. But many businesses are in a period of suspended animation as the so-called ‘cliff-edge’ of dealing with – for so many – novel financial circumstances has been simply postponed. Increasingly we are also identifying businesses that will experience ‘long COVID’; that is, businesses that inherently have the capacity to thrive beyond this crisis but which will need to be nursed financially through a period of rehabilitation. The approach adopted by the banks to forbearance and recovery will be paramount.

It is vital that SG has a clear position, based in part on the specific characteristics of businesses in Scotland, to contribute to the framework developed by UK Government and the banks. We must also identify innovative ways in which we can act unilaterally to improve not only finance but also the accompanying support services. This is perhaps an opportunity too to tackle structural deficiencies such as the limited availability and use of venture capital finance in Scotland.

As a small advanced economy, we have the capability to act with greater agility than many others. In particular we must address the essential importance of collaboration as we plot our way forward. Our ambition for Scotland to create a robust, resilient wellbeing economy must not be thwarted.

The group that contributed to this report must be commended and thanked for their commitment, openness, and transparency. Needless to say it should not be assumed that all who participated would agree with every comment that is set out in this final report.

Benny Higgins

Contents

Executive Summary

Background

The Cabinet Secretary for Economy, Fair Work and Culture wrote to me on 23 September, inviting me to convene a working group to advise Ministers on recapitalisation, equity investment and any other issues considered pertinent to financing economic recovery. This request was made in response to the recommendation of the Advisory Group on Economic Recovery (AGER) that the Scottish Government should use its convening power to coordinate policy approaches to economic recovery in close liaison with financial services institutions.

Ten recommendations are made across four areas of focus: Economic Overview, Financing Business Survival and Resilience, Financing Opportunity and Growth, and Business Support and Collaboration.

Part 1: Economic Overview – Key Findings

In this section I summarise the key economic evidence that best contextualises my analysis and recommendations. I identify six critical points:

1. UK Government loan schemes has **vastly increased the debt** carried by Scottish businesses.
2. **Demand for finance has been, and remains, significant**, but more than half of business borrowing remains unspent.
3. UK Government loan guarantees and the relaxed viability/affordability checks for access to schemes has **increased the supply of debt finance.**
4. The relaxed affordability checks presents future risk. **Ability to repay is precarious**, potentially leading to business distress at scale and limiting future access to additional finance for resilience and growth.
5. Beyond the emergency **we face economic 'long-COVID'**: the economy will take time to ramp back up and heavily indebted businesses will struggle to access the capital necessary to drive growth and recovery. These effects are likely to have sectoral and regional dimensions.
6. **EU Exit will compound these challenges** and could extend them to sectors that may otherwise have coped relatively well with the pandemic.

Together, these findings present an extremely challenging economic context.

Part 2: Financing Business Survival and Resilience – Key Findings

In this section I define 'recapitalisation' as the measures necessary to help the economy recover from diminished revenues and significant new exposure to debt.

To succeed, any recapitalisation package must therefore achieve two objectives:

- **managing debt exposure** to prevent it from causing businesses to fail on a **mass scale**; and
- providing **access to new capital** to drive recovery, through investment in growth, sustainability and innovation.

The remainder of Part 2 is focused on meeting the first of these objectives: effective and fair debt management. In the first half of 2021, the economy faces a ‘cliff edge’ at which furlough and other support schemes end just as repayments on loans and deferred taxes begin to fall due. Due to the sheer scale of this problem, it is one best addressed through the fiscal and regulatory levers available to the UK Government. The imperative for Scottish Ministers is to influence this work, ensuring it is sufficiently ambitious and that it is responsive to the needs of the Scottish economy.

I therefore propose a range of positions on recapitalisation which, together, could act as a credible engagement agenda for Scottish Ministers to pursue with the UK Government. I identify six key objectives for that engagement:

1. **Extend Forbearance** i.e. seek to delay loan repayments and extend support schemes; allowing businesses time to re-establish revenues and save jobs.
2. **Extend the Trade Credit Insurance Guarantee beyond 30 June 2021** – this is crucial support that protects supply chains and underpins business-to-business transactions.
3. **Secure flexible repayment terms**. Businesses, sectors and communities are not all created equally and it is important that lenders have discretion to work with businesses to find individual solutions that allow for restructure and refinancing.
4. We need an agreed **framework to manage and recover coronavirus loan debt in a way that is clear and fair**. Recovery processes should be transparent, sympathetic and consistent. Similarly, insolvency procedures should be streamlined with expertise made available to ensure ‘soft landings’ for distressed businesses.
5. We will require **new finance schemes to bridge the gap between the pandemic and normal market conditions**. These successor loan schemes must be ambitious, flexible and responsive to the needs of the Scottish economy.
6. Ensure small and medium-sized enterprises (SMEs) can seek **meaningful redress for unfair treatment** – this was a problem following the 2008 financial crisis and one that has yet to be fully resolved.

Part 3: Financing Opportunity and Growth – Key Findings

In Part 3 I look beyond the immediate crisis towards the longer-term challenge of providing access to new capital for the many businesses who are now heavily debt leveraged. Injecting capital is critical to ensure that businesses can drive recovery through investment in growth, innovation and sustainability.

To that end, I argue that there is scope to expand the use of patient equity investment across more traditional sectors of the economy normally considered unsuitable for this kind of investment. Making this work would require commitment and imagination. I therefore propose that the Scottish National Investment Bank (SNIB) and Scotland’s world-class asset management industry should collaborate to develop new approaches that stimulate the interest of both investors and a new class of potential investees. I also highlight similar discussions taking place at UK level and propose that Ministers ensure Scottish interests are represented.
In addition to providing access to new capital, an increase in patient equity investment provides opportunities for the Scottish financial services industry.

I also consider Scotland's more established market for equity investment in high growth businesses. Here, I echo the findings of Mark Logan's *Scottish Technology Ecosystem Review*; arguing that, despite the overall strength of the Scottish market, there is a concerning absence of venture capital activity and that we therefore need to increase the density and diversity of capital. I propose this could be achieved by pro-actively developing relationships with venture capital (VC) firms; putting energy and resource into showcasing Scotland's best high growth prospects and considering state-backed capitalisation of privately-operated VC funds with a remit to investing in Scottish companies. I close Part 3 by highlighting the economic opportunities of establishing Scotland as a hub for green finance, investment and innovation.

Part 4: Business Support and Collaboration – Key Findings

In Part 4, I depart from my core remit of advising on financing recovery to offer brief commentary on the support that businesses will need, beyond the purely financial, to cope through a period of unprecedented challenge. The advice offered on these issues is not exhaustive and should be considered as a brief addendum to my main findings on financing recovery. I conclude that there has never been a greater need for the private and public sectors to work together to improve the quality, accessibility and intensity of advice and support for businesses. Scotland is a small country with a relatively small number of key economic institutions and networks. I suggest that it should be possible to leverage this to our advantage through more pro-active sharing of intelligence and networks to facilitate businesses' access to new funding, partners and markets.

In the field of financial services, I propose a new model for industry engagement for further discussion between Scottish Financial Enterprise (SFE) and Ministers. I also introduce the first iteration of the SFE 'Banking Barometer' a monthly report which summarises aggregated real-time data from seven key Scottish banks. This is the first time that data of this kind has been made available to Ministers and has the potential to be a powerful new tool to inform policy development.

I finish the report with a reminder that Scotland faced economic challenges prior to the pandemic and that the effect of these 'old' problems is likely to be amplified. I propose that in planning longer-term economic strategy, attention should be paid to programmes which encourage investment in new technologies and innovation; improved leadership capability and mechanisms to diffuse best practice from highly productive firms to the wider economy.

Table of Summarised Recommendations[1]

	Responsibility				
Recommendation	**Scottish Government**	**Industry/ banks**	**Enterprise Agencies**	**SNIB**	**Business Organisations**
1. Seek **strategic route map** to delay and intelligently schedule loan repayments.	Engage with UK Government (UKG).	Report through Banking Barometer.			
2. Create a nationally agreed **debt management framework**.	Engage with UKG.	Report through Banking Barometer.			
3. Influence design of **successor loan schemes** ensuring fair access to finance.	Engage with UKG.	Report through Banking Barometer.			
4. Identify **distressed businesses** that play an important role in key supply chains and support financially and strategically.	Coordinate delivery of support to distressed businesses.	Help identify businesses & contribute to support. Report through Banking Barometer.	Help identify businesses and contribute to support.		Help identify businesses and contribute to support.
5. Explore expansion of **patient equity instruments**.	Initiate work from SNIB.	Collaborate with SNIB.		Collaborate with asset managers.	
6. Diversify Scotland's high growth investment market.	Attract VCs. Consider establishing new funds.	Advise on strengthening investment market.	Advise on strengthening investment market.		
7. Use COP26 to showcase Scotland as a hub for green finance & investment.	Develop plan with SFE/SNIB.	Develop plan with SG/SNIB.		Develop plan with SG/SFE.	
8. Public/private collaboration to improve quality, intensity & accessibility of business support.	Coordinate work. Develop policy.	Contribute to design & delivery of improved business support.	Contribute to design & delivery of improved business support.		Articulate needs of businesses & ensure design & delivery is of sufficient quality.
9. Harness shared networks to facilitate new contracts and access to markets.	Convene discussion.	Develop industry contribution.	Develop public sector contribution.		Articulate needs of businesses.
10. Take account of 'old' challenges in planning future economic challenges.	Lead policy development.				

[1] The recommendations are set out in much greater detail in the body of the advice.

Part 1- Economic Overview

Introduction

The COVID health emergency is having an unprecedented impact on businesses across Scotland and this will have consequential economic and social costs in the years ahead. The remedy of UK Government loan schemes, facilitated by the banks, has temporarily deferred many of these consequences, but in time will bring new risks to the balance sheets and sustainability of Scottish businesses. Understanding and effectively managing these risks is critical to avoiding a “drag effect” on recovery, innovation, productivity and growth.

I am mindful that Ministers will be receiving regular updates on these matters from the SG’s Office of the Chief Economic Adviser (OCEA) and, for that reason, I have chosen to provide only an overview of the **critical points** which best contextualise my commentary and recommendations.

Critical Point 1: UK Government loan schemes have vastly increased the debt carried by Scottish businesses

Overview
Just over a third (35%) of businesses in Scotland applied for support from UK Government-backed loan schemes and 30% of businesses were successful in receiving funding[2]. Businesses in Scotland secured around 6% of the volume of CBILS and BBLS loans, in line with Scotland’s share of the business base[3].

Bounce Back Loan Scheme (BBLS)
BBLS provides up to six-year terms for loans of £2,000 up to 25% of turnover (capped at £50,000)[4]. The UK Government provides lenders with a 100% guarantee against loss and, for borrowers, covers the first year of interest and fees. Borrowers do not require to make repayments for the first 12 months. The scheme is scheduled to close in March 2021, although firms in receipt of loans can now take advantage of more flexible repayment terms under the newly-announced ‘Pay As You Grow’ scheme.

Coronavirus Business Interruption Loan Scheme (CBILS)
CBILS provides loans and other finance facilities of up to £5 million. Loans can be repaid over six years. The UK Government provides lenders with an 80% guarantee against losses. No personal guarantees are taken for facilities under £250,000. Over £250,000, personal guarantees are at the discretion of the lender, but debt recoveries are capped at 20% of the outstanding balance. A Principal Private Residence cannot be taken as security to support a personal guarantee for a CBILS-backed facility. The scheme is scheduled to close in March 2021.

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[2] Scottish Government, Business Impacts of Coronavirus (COVID-19) Survey (BICS) – Weighted Scotland Estimates: Wave 16. Data is for businesses with 10 or more employees with a presence in Scotland and relates to the period 19 October to 1 November 2020.
[3] British Business Bank, CBILS and BBLS Regional and Sector Lending Data. Data to 10 January 2021.
[4] Under the Pay As You Grow facility, businesses can apply to extend the BBLS loan term to 10 years.

Data to January 2021 shows that 86,062 loans worth £2.5 billion have been offered across Scotland under BBLS. 4,144 loans worth £983 million have been offered across Scotland under CBILS[5].

Critical Point 2: Demand for Finance is significant, but more than half of business borrowing remains unspent

Just under half of UK businesses surveyed in June 2020 anticipated needing more credit as a result of the pandemic, with the majority expecting the credit needed to be available[6]. The proportion of UK businesses using finance has increased since the start of the pandemic, from 32% in 2020 Q1 to 44% in Q4[7]. The banks report that SME borrowing has increased at an unprecedented rate of 21% compared with last year. Alongside this, there has been a fall in the proportion of UK SMEs defining themselves as 'permanent non-borrowers' (not currently using finance and having no inclination to do so) from 50% in 2020 Q1 to 32% in Q4[8]. It indicates businesses' increasing need and willingness to borrow to cope with the impacts of the pandemic. For many of these businesses, the pandemic is the first time that they have accessed term debt finance.

There has also been a rise in the proportion of UK SMEs injecting personal funds into the business with almost four in ten (38%) doing so in 2020 Q4, up from 24% in 2020 Q1 and in line with levels last seen in 2013[9]. Demand for credit has softened since the initial surge in applications for Government-backed loans, with the latest data from the Bank of England indicating that demand for corporate lending from small and medium-sized businesses fell slightly in 2020 Q4 but increased for large businesses[10]. Looking ahead, businesses' demand for finance will depend, amongst other things, on the level of cash reserves held and how the pandemic develops, including the potential need for further restrictions and the related pace of recovery in the most impacted sectors.

The latest data shows that businesses' cash reserves have actually increased during the pandemic[11], likely due to the injection of funds from Government-backed loans and other Government support such as furlough. The extension of furlough and the loan scheme flexibilities announced as part of the Winter Economy Plan will mitigate the expected acceleration in the rate at which businesses will require to use up this capital. This will likely delay the anticipated economy-wide 'cliff edge' from the end of 2020 to the first half of 2021.

[5] British Business Bank, CBILS and BBLS Regional and Sector Lending Data. Data to 10 January 2021.
[6] Bank of England, June 2020, Decision Maker Panel
[7] BVA-BDRC, January 2021, SME Finance Monitor: 3 Month Rolling Analysis to end December 2020
[8] Ibid.
[9] Ibid.
[10] Bank of England, January 2021, Credit Conditions Survey 2020 Q4
[11] BVA-BDRC, January 2021, SME Finance Monitor: 3 Month Rolling Analysis to end December 2020

Critical Point 3: UK Government Loan Guarantees increased the Supply of Debt Finance

The supply of finance to UK businesses has increased considerably in the months following the onset of the COVID-19 pandemic, with businesses raising significant sums in loans, equity, bonds and commercial paper. Approximately 40% of finance to businesses has come from loans[12].

Reflecting the significant uptake of UK Government-backed loans, the latest data for Scotland shows a spike in new loans to SMEs in 2020 Q2 followed by a smaller increase in Q3, driven by lending to small businesses[13]. In the UK as a whole, the growth rate of net lending to UK businesses was at its highest point for over ten years in June 2020 (10.9%), with the latest data for December continuing to show strong growth (9.5%)[14].

Following a significant improvement in credit availability for UK businesses in 2020 Q2 and a moderate improvement in Q3, overall availability was broadly unchanged in Q4, decreasing for small businesses and remaining unchanged for medium and large firms. Overall credit availability was not expected to change in 2021 Q1[15]. The longer the impacts of the pandemic persist, the more likely it is that cash reserves will fall in the months to come, potentially triggering a second surge in demand for finance.

A new surge may be challenging; state backed schemes are scheduled to end in March and many businesses are already heavily debt leveraged, calling into question their onward viability. This makes the design of successor finance schemes, innovative use of equity and fair streamlined recovery processes, crucial. All of these issues are explored in detail in the proceeding sections of this advice.

Critical Point 4: Lack of affordability checks for BBLS presents future risk

Whilst debt taken on by businesses during the pandemic has been crucial in helping them to survive, it has raised concerns about ability to repay and the impacts on growth if cash flow is directed towards servicing debt at the expense of investment. It is estimated that between **35% and 60% of borrowers may default on BBLS loans**[16]. In 2020 Q3, around a fifth (21%) of UK SMEs were concerned about their ability to repay finance over the next 12 months[17]. Half (51%) of UK company directors surveyed in May 2020 said that debt taken on during the crisis would have a negative impact on their recovery[18].

This analysis perhaps reflects the fact that no assessment of viability or loan affordability was undertaken as part of the BBLS process; making it difficult to model

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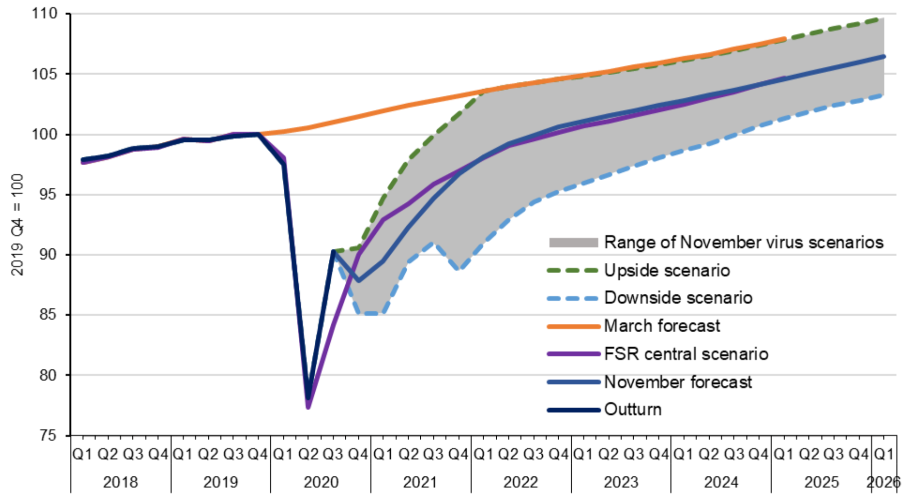
[12] Bank of England, Net Finance Raised from Banks, Building Societies and Capital Markets. Data is for businesses in the UK as a whole for the period March to December 2020.
[13] UK Finance, December 2020, SME Lending and Deposits – Great Britain, 2020 Q3.
[14] Bank of England, Monthly 12 Month Growth Rate of M4 Lending (monetary financial institutions net lending to private sector), Seasonally Adjusted. Data to December 2020.
[15] Bank of England, January 2021, Credit Conditions Survey 2020 Q4
[16] National Audit Office, October 2020, Investigation into the Bounce Back Loan Scheme
[17] BVA BDRC, September 2020, SME Finance Monitor 2020 Q3
[18] Institute of Directors, June 2020, Policy Voice Poll

the future performance of businesses. This will present challenges to both borrowers and commercial lenders when assessing the affordability of additional finance.

Critical Point 5: Beyond the Emergency we face Economic 'Long-COVID'

There is emerging evidence that businesses are likely to experience what might be described as 'economic long-COVID'. Even as the public health crisis eases, the challenges affecting the economy will persist over the medium to long-term, with compounding impacts on businesses and households. The latest Office for Budget Responsibility (OBR) forecasts indicate, in the central scenario, a very gradual recovery in economic activity where real GDP does not return to pre-COVID levels until 2023 (see Chart 1)[19]. The OBR also forecasts unemployment peaking in Q2 of 2021 and only returning close to pre-COVID levels in 2024. In short, the pandemic and its economic impact may weigh down businesses for years to come.

Chart 1: UK Real GDP Paths



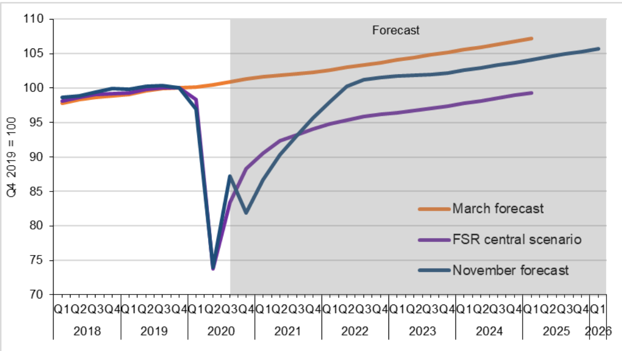
Source: Office for Budget Responsibility, November 2020, 'Economic and Fiscal Outlook – November 2020'

A further symptom of this economic long-COVID is its lasting impact on economic demand. Chart 2 from the latest OBR forecasts show that real private consumption and real business investment are likely to remain depressed below pre-pandemic levels for an extended period[20].

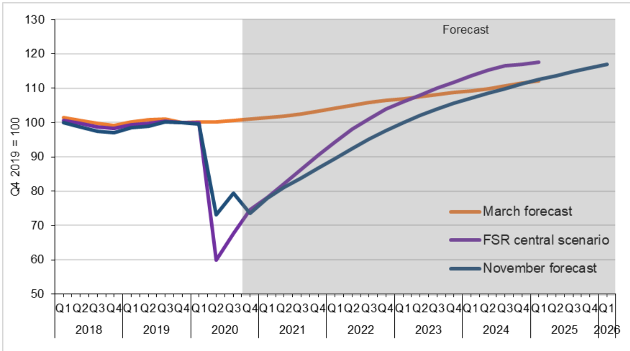
[19] Office for Budget Responsibility, November 2020, Economic and Fiscal Outlook – November 2020
[20] Ibid.

Chart 2: UK Real Private Consumption and Real Business Investment Forecasts

(i) Real Private Consumption



(ii) Real Business Investment



Source: Office for Budget Responsibility, November 2020, 'Economic and Fiscal Outlook – November 2020'.

There will, however, be variability in the extent to which different parts of the economy will experience this phenomenon. The sectors that have been most exposed to COVID impact are most likely to emerge from the pandemic considerably weaker, impacting on their pace of recovery and resilience to further shocks in the recovery phase. OCEA's assesment of sectors by COVID exposure (See Table 1) suggests the following sectors are likely to be most exposed to the risk of 'long-COVID' depending on impact channel:

- **International Demand:** agriculture, forestry and fishing; mining and quarrying industries (largely oil and gas); and, parts of manufacturing.
- **Domestic Demand:** accommodation and food services; administrative and support services; arts entertainment and recreation; and, other services.
- **International Supply:** manufacturing; and, accommodation and food services.
- **Labour Market Disruption:** retail and wholesale; and accommodation and food services.

Table 1: OCEA Assessment of Sectoral Exposure to COVID-19 Impact Channels

Sector of Economy	International Supply	International Demand	Domestic Demand	Labour Market Disruption
Agriculture, Forestry and Fishing	Amber ↑	Red ↑	Yellow ↔	Yellow ↔
Mining and Quarrying Industries	Amber ↑	Red ↑	Amber ↔	Yellow ↔
Manufacturing	Red ↔	Red ↔	Amber ↔	Amber ↓
Electricity & Gas Supply	Yellow ↔	Yellow ↔	Yellow ↔	Yellow ↓
Water Supply & Waste Management	Amber ↑	Yellow ↔	Yellow ↔	Amber ↑
Construction	Amber ↑	Amber ↑	Amber ↓	Yellow ↓
Retail & Wholesale	Amber ↑	Amber ↑	Amber ↓	Red ↔
Transport & Storage	Amber ↑	Amber ↑	Amber ↔	Amber ↔
Accommodation & Food Services	Red ↑	Amber ↔	Red ↔	Red ↔
Information & Communication	Amber ↔	Amber ↑	Amber ↑	Yellow ↔
Financial & Insurance Activities	Amber ↑	Amber ↑	Yellow ↔	Amber ↔
Real Estate Activities	Yellow ↔	Amber ↑	Yellow ↔	Yellow ↓
Professional, Scientific & Technical Services	Amber ↑	Amber ↔	Amber ↑	Yellow ↓
Administrative & Support Services	Amber ↑	Amber ↑	Red ↑	Amber ↓
Public Administration and Defence	Yellow ↓	Yellow ↔	Yellow ↔	Amber ↓
Education	Yellow ↔	Amber ↔	Amber ↑	Amber ↓
Health and Social Work	Yellow ↓	Yellow ↔	Amber ↑	Red ↔
Arts, Entertainment and Recreation	Yellow ↔	Yellow ↔	Red ↔	Yellow ↓
Other Services	Yellow ↔	Yellow ↔	Red ↑	Amber ↓

Key
Yellow = Lowest Risk Rating
Amber = Medium Risk Rating
Red = Highest Risk Rating
Arrows show change since April's assessment
↑ shows where a sector is upgraded to higher rating
↓ shows where a sector is downgraded to lower rating
↔ shows where a sector's rating is unchanged

Source: Office of the Chief Economic Adviser, Scottish Government (assessment as at October 2020)

The ONS Business Impact of Coronavirus Survey (BICS) indicators suggests that the sectors which are most exposed to these COVID impact channels are among the main that have been most weakened by the pandemic.

For example, over the period 5 – 18 October 2020, the sectors reporting high to moderate risk of insolvency include: accommodation and food services (36%); transport and storage (29%); manufacturing (20%); administration and support services (16%); arts, entertainment and recreation (at least 12%) and construction (10%)[21].

Further, the ONS BICS survey shows that over the pandemic period, investment across all sectors of the economy has been depressed. A third (33%) of businesses in Scotland report that capital expenditure has been lower than normal or stopped entirely as a result of the pandemic. This trend is more pronounced among larger businesses (250+ employees) than small enterprises[22].

While reduced capital expenditure may represent general uncertainty in the business environment, it may also be a result of businesses pivoting their resources to surviving the impacts of the pandemic, instead of longer-term investment.

In summary, the evidence shows that many businesses, especially in sectors most impacted by the pandemic:

- will struggle to immediately generate sufficient cash to start making repayments against loans they have taken as a result of the distress caused by the pandemic;

- will emerge from the pandemic in a weakened state and may require access to additional finance to rebuild and to weather the period of gradual recovery until they return to conditions close to business as usual;

- will be forced to direct funds towards debt repayment at the expense of investment in growth, productivity, jobs and wages;

- will be in a weakened state to cope with any further disruptions to the business environment, either by the pandemic or EU exit, and will be reliant on the State and the financial sector for support to deal with any further negative shocks.

The analysis reinforces the need to ensure that debt repayments are manageable and can co-exist with access to capital for investment in growth. It also signals the possible need for Government initiatives to shift from universal support towards targeted support for the most distressed sectors and communities.

[21] Scottish Government, Business Impacts of Coronavirus (COVID-19) Survey (BICS) – Weighted Scotland Estimates: Wave 15 (5 – 18 October 2020).
[22] Scottish Government, Business Impacts of Coronavirus (COVID-19) Survey (BICS) – Weighted Scotland Estimates: Wave 21 (29 December 2020 – 10 January 2021).

Critical Point 6: EU Exit will compound these impacts

The UK's departure from the EU will amplify these challenges and could extend them to sectors that may otherwise have coped relatively well with the pandemic.
The OBR's baseline scenario estimates that under a Free-Trade Agreement (FTA) UK GDP will be around 4% lower in the long run compared to continued EU membership[23].

The Bank of England has updated its assessment now that the Trade and Cooperation Agreement has been agreed, concluding that additional barriers to trade will result in trade between the UK and EU being lower than it otherwise would have been under continued Single Market membership. This in turn is expected to reduce investment, productivity and GDP. GDP is projected to be around 3.25% lower in the long run due to lower trade with the EU[24].

Immediate and short-term effects of leaving the Single Market include the introduction of non-tariff barriers to trade with the EU, increased disruption to supply chains already experiencing challenges due to COVID-19, and heightened uncertainty in some markets. These barriers are concentrated in areas of manufacturing, food and drink, agriculture and fisheries.
These sectors most exposed to increases in trade costs with the EU have largely been relatively less impacted by COVID. Over the longer term, productivity impacts and lower migration arising from leaving the EU become more important drivers of growth forgone, with implications for all sectors of the economy relative to remaining in the EU Single Market.

Part 2: Financing Business Survival and Resilience

Introduction

Recapitalisation is a term that has gained traction in recent months; used frequently by economists, bankers and policymakers who sometimes appear to mean different things. It is therefore important to be clear about what *we* mean by it. In my estimation, recapitalisation refers to the package of measures required to help the economy recover from diminished revenues and new exposure to debt. To succeed, any recapitalisation package must therefore achieve two objectives:

- **managing debt exposure** to prevent it from causing businesses to fail on a mass scale; and
- providing **access to new capital** to drive recovery, where opportunities exist, through investment in growth, sustainability and innovation.

In Part 2 of this advice I focus on the first of these criteria: aiding business survival and resilience through effective debt management. As we shall see, while most discussions of this recapitalisation tend to focus on *injecting* capital into the economy, it is just as important for Governments to consider how best to manage the *extraction* of capital by intelligently managing the timing, intensity and methodology of debt recovery.

[23] Office for Budget Responsibility, November 2020, Economic and Fiscal Outlook – November 2020
[24] Bank of England, February 2021, Monetary Policy Report

The issues explored in Part 2 are mass scale, economy-wide challenges that impact upon businesses of every size and sector. For that reason, they are matters best addressed through the fiscal and regulatory levers available to the UK Government. In some cases I am aware that work is already underway to consider how these challenges should be addressed. The imperative for Scottish Ministers is to influence this work, ensuring that it is sufficiently ambitious and responsive to the needs of the Scottish economy. I have framed my analysis accordingly, proposing a set of positions which, together, can act as a new and credible engagement agenda for Scottish Ministers to press with their UK counterparts.

Engagement Objective 1: Extend Forbearance

A convergence of timelines brings specific risk to the Scottish economy in the first half of 2021. Businesses will face a 'cliff edge' at which furlough and other support schemes end just as repayments on loans and deferred taxes begin to fall due. This double pressure will emerge against the backdrop of the economic 'long-COVID' phenomenon described earlier.

In many sectors, revenues will take time to recover as supply chains ramp back up, order books refill, household finances recover and consumer behaviour reverts to something resembling normality. The scars of the pandemic will weaken the ability of businesses to drive recovery, with increased debt dampening investment and acting as a drag on job creation and productivity. The uncertainty and additional economic disruption caused by EU exit will compound these challenges.

This will trigger an inflection point, at which we will see a crystallisation of unsustainable debt, defaults and significant levels of business restructuring and failure. This, in turn, will impact upon jobs and household finances. As the evidence presented demonstrates, it is near certain that these consequences will have sectoral and regional dimensions.

We therefore welcome the introduction of the UK Government's Pay As You Grow scheme which will help companies better manage their Bounce Back Loan repayments, although this facility has not yet been extended to other Government backed loan schemes; rather than extracting capital at precisely the moment businesses need it most to retain jobs and trade their way out of a post-pandemic, post-Brexit crisis. This was a message that came through strongly in all of the engagement that we have had with businesses of multiple sizes and across multiple sectors.

Engagement Objective 2: Extend the Trade Credit Insurance Guarantee beyond 30 June 2021

Trade credit insurance (TCI) plays a critical role in underpinning business-to-business transactions. It provides cover for businesses if customers who owe money for products or services do not pay their debts, or pay them later than agreed payment terms dictate. It gives businesses the confidence to extend credit to new customers and improves access to funding, often at more competitive rates.

The Trade Credit Insurance (TCI) Guarantee Scheme, introduced by the UK Government in June 2020, ensures that TCI products remain available and affordable. While it has attracted less attention than the more high profile loan schemes, businesses are clear that the TCI has been a significant help in supporting them to maintain productive capacity.

Initially this Scheme was due to end in December 2020 but it has now been extended to 30 June 2021. While this is welcome news, trading conditions are unlikely to have returned to normal by this stage and the risk of businesses failing to pay invoices will increase over the full course of 2021. It is likely that TCI products will become scarce and expensive, eroding confidence in business-to-business transactions. This makes a further contribution to the cliff edge scenario in which withdrawal of support and new cash pressures coalesce.

Recommendation 1: The Scottish Government should seek to work with the UK Government to develop a route map that more strategically schedules the repayment of loans and deferred taxes, and Scottish Ministers should consider pressing for a longer extension of the Trade Credit Insurance Guarantee Scheme.

While those who can pay should be encouraged and incentivised to do so, the objective of this route map is to avoid an economy-wide cliff edge, potentially in a way that is sensitive to the acute challenges faced by particular sectors and regions, and which takes account of the need to incentivise innovative companies to invest for growth.

Engagement Objective 3: Secure flexible repayment terms

As part of the Winter Economy Plan, the UK Government announced changes to the repayment terms of both BBLS and CBILS. BBLS can now be repaid over six years, with the option to pause payments for up to six months and to revert to periods of interest only payments. The Chancellor’s February 2021 ‘Pay As You Grow’ announcement introduces further flexibility in allowing firms in receipt of Bounce Back Loans to extend the term period from six to ten years.

Whilst these measures have been welcomed by business, it is arguable that they do not go far enough and that there is scope for more flexible arrangements that can be tailored to the needs of individual businesses, sectors and localities. For example, for the owners of very small businesses there is often little distinction between their personal and business finances – business distress translates to household distress. For businesses of this kind, especially where they are otherwise viable and provide employment, there is an argument for a student loans style approach, in which repayment is dependent on tests of revenue and affordability.

For larger, more innovative businesses the imperative is to encourage them to drive recovery through investment in growth and job creation. For many, this will require access to additional debt finance and it is important that lenders have the flexibility to consider these matters in the round, e.g. to offer businesses the opportunity to restructure and re-profile coronavirus debt to unlock the capacity to invest.

More generally, it may be helpful to offer banks and other lenders the discretion to use their knowledge of local markets and relationships with customers to craft individualised solutions that would strengthen business resilience and potentially reduce the risk of defaults. Such discretion could be an effective means of diluting and more thinly spreading economic risk, avoiding the economy-wide cliff edge earlier described.

Engagement Objective 4 – We need a framework to fairly manage and recover coronavirus loan debt

However much we seek flexibility and delay, the reality is that repayments will require to begin sometime and, inevitably, there will be businesses who find themselves unable to pay. It bears repeating that the scale of the risk is unprecedented – anywhere between 35% and 60% of borrowers may default on BBLS alone[25].

Despite the imminence of this risk, there remains uncertainty over the UK Government's expectations of lenders in relation to recovery processes and how, for example, the guarantees underpinning loan schemes will work in practice. As well as causing confusion for lenders and businesses, this leaves open the possibility of lenders adopting inconsistent approaches to recovery, raising questions of fairness for customers and possible reputational damage to institutions.

This issue matters for other reasons too. As the evidence I have presented makes clear, the profile of the Scottish economy is such that default trends are likely to emerge on a sectoral and geographic basis e.g. tourism businesses in the North. It is therefore important that Governments and banks reflect carefully on how is the recovery procedures deployed in pursuing repayment may impact upon communities and livelihoods. The potential for defaults on an unprecedented scale also presents challenges of a more practical nature and it is unclear whether these have benefitted from sufficient thought.

Due to sheer volume, distress and recovery processes will require to be streamlined and, in the interests of fairness, it is important that businesses have the opportunity to seek the appropriate advice e.g. from turnaround specialists whose expertise can help restore viability and from insolvency practitioners who can help salvage jobs and value from distressed businesses.
It is presently unclear how such expertise could be made available at the scale necessary – making reducing the risk of default all the more important.

Recommendation 2: The Scottish Government should consider pressing UK Ministers on the creation of a comprehensive, nationally agreed framework for the management of debt incurred as a result of the pandemic. Such a framework should:

- **Provide a <u>flexible repayment model</u> allowing for lender discretion that is sensitive to business size, communities and sectoral impact.**
- **Provide the opportunity to refinance or restructure coronavirus debt in circumstances where it encourages access to growth capital.**
- **Consider a student loan style model for small businesses, with payments contingent on income and deducted through the tax system.**

[25] National Audit Office, October 2020, Investigation into the Bounce Back Loan Scheme

- **Ensure that recovery processes are clear, fair and universally applied.**
- **Outline streamlined and sympathetic insolvency procedures that offer a 'soft landing' for distressed businesses, including tackling the issue of mass access to turnaround and insolvency expertise.**

The Banking Barometer should be used to monitor the performance in Scotland of such a framework over time.

Engagement Objective 5: Ensure that successor loan schemes are ambitious, flexible and responsive to the needs of the Scottish economy.

The UK Government and lenders will require to adapt to a new economic reality, requiring flexibility and new models for considering the question of viability and the risk of new debt in circumstances where many SMEs are already heavily leveraged. A key element of the solution is to ensure that well-designed successor schemes are in place to bridge the gap between the end of CBILS and BBLS and the return of normal market conditions. The Chancellor's Winter Economy Plan acknowledged as much with its commitment to a reformed Enterprise Finance Guarantee Scheme[26]. In the following recommendation I highlight some of the key features that may be desirable in such a scheme if it is to act as an effective support for Scottish businesses.

Recommendation 3: The Scottish Government should seek to influence the discussions between HM Treasury and UK Finance over the design of successor loan schemes, ensuring their terms and structure meet the needs of Scottish businesses.

Particular features that Ministers may wish to press for include:

- **Responding to the needs of Scotland, where many small businesses will require cheap access to relatively small loans.**

- **The ability to fairly refinance and restructure coronavirus loans, alongside accessing new capital for growth.**

- **Replicating the extended repayment terms already introduced for BBLS and CBILS.**

- **Portability, allowing businesses to refinance and move between lenders as part of their personal recovery plans. This would facilitate competition between lenders, to some extent easing market distortion.**

- **A flexible approach to underlying scheme rules e.g. a new, post-pandemic model of assessing viability that allows lender risk committees to act with discretion and to more fully consider the circumstances of individual businesses and their markets.**

[26] EFG facilitates lending to smaller businesses that are viable but unable to obtain finance from their lender due to insufficient security. EFG provides the lender with a government-backed guarantee of up to 75%.

- **As far as possible maintaining the significant process improvements seen through the operation of CBILS and BBLS both of which were simple, fast and digital.**

- **Broadly maintaining the progressive approach taken under CBILS and BBLS to Government-backed guarantees and minimising the need for personal guarantees.**

- **Ensuring that lender accreditation is extended widely, including to alternative non-bank lenders; fostering competition and ensuring there is adequate coverage in Scotland. This should include the Scottish Government's own commercial loan schemes.**

Engagement Objective 6: Ensure SMEs can seek meaningful redress for unfair treatment

It is important to learn lessons from the 2008 financial crisis when banks received a substantial volume of complaints from SMEs about their handling of broadly similar issues. The industry has changed significantly since that period but it remains important that businesses have access to meaningful redress without resorting to unaffordable legal action. Ministers will wish to note that the banks have collaborated with SMEs to create a new, UK-wide Business Banking Resolution Service (BBRS) which will handle complaints and dispute resolution for smaller SMEs.
It may be useful for Scottish Government officials to engage with the leadership of BBRS to ensure that sufficient coverage is being extended in Scotland.

Supply Chain Pressures

The impact of financial distress often cannot be isolated to an individual business. Distress often carries a contagion effect, where financial pressures and disruption spread quickly through supply chains. For example, if a large firm at the top of a supply chain is unable to access sufficient TCI coverage, this will likely reduce its credit limits. It will then be forced to use cash to pay invoices and will be more careful in its dealings with suppliers: issuing stricter payment terms, calling in invoices from creditors and potentially placing fewer orders. This, in turn, impacts on the credit ratings and behaviours of businesses right through the supply chain, damaging liquidity and weakening the resilience of the entire chain. In some cases, this alone will be sufficient to trigger business failures. The CBI reports that there is already evidence of pressure building in supply chains and EU exit will see that pressure intensify.

Recommendation 4: Banks, business organisations and enterprise agencies should collaborate to identify distressed businesses that play an important role in key supply chains. Once identified, and where appropriate, the Scottish Government should collaborate with the relevant bank and enterprise agency to deliver the strategic and financial support necessary to protect the supply chain.

Part 3: Financing Opportunity and Growth

1. Introduction

My commentary so far has focused on strengthening business resilience through effective management of debt - the first of the two criteria I identified for successful recapitalisation. In Part 3 I turn to the second: injecting new capital to drive recovery through investment in growth, sustainability and new opportunities. With access to debt finance already covered extensively, I will focus my analysis on the role of equity investment and, in particular, how we might facilitate the market conditions necessary to expand the use of equity instruments in the traditional economy and to address structural weaknesses in the equity market for high growth industries. I will close the section with a detailed treatment of the significant economic opportunities for Scotland in the emerging field of green finance.

2. Patient equity for traditional SMEs

Third party equity investment is a solution most commonly applied to large, innovative or young startup/scale-up businesses[27] with significant growth potential. In contrast, Scotland's economy is largely composed of more traditional SMEs with little culture or experience of sacrificing equity for capital and, in any case, where there is often limited growth potential to attract investors. The received wisdom is therefore that equity investment is only suitable for a small subset of the economy.
But, in a time of crisis, this lack of existing large scale application does not mean that equity investment is irrelevant for traditional industries; especially in circumstances where many businesses are now in no position to take on further debt and where we may well see a consolidation of SMEs through mergers and acquisitions to create larger, more investable enterprises. It is therefore worth considering whether an imaginative, targeted expansion of equity into non-traditional sectors could form part of Scotland's recovery strategy. Equity investment is a flexible instrument and, for those businesses for whom it could be useful, it could offer at least four benefits:

- First, it removes debt burden from balance sheets, preventing companies from holding back on investment and job creation while they concentrate on reducing debt. Such a trend could accumulate to a drag on future growth and productivity – it is precisely the kind of 'frontier' companies best suited to equity investment that we need to lead recovery by pressing on with growth and innovation.
- Second, such deleveraging of debt allows companies the space and flexibility to access new debt finance from a position of strength and for reasons that are beneficial to the economy e.g. capital investment or expansion instead of aiding survival.
- Third, it strengthens the economy's resilience to future economic shocks.. Heavily debt leveraged companies will find it more difficult to refinance and borrow their way out of any future crises.
- Fourth, equity investors can provide new expertise in terms of leadership, strategy and networks to reach new markets and customers.

[27] Equity for high growth businesses is discussed below.

Expanding the use of equity in more traditional sectors may require Governments to work with the market to shape instruments more appropriate to businesses whose operating models, markets and growth trajectory will be very different to their usual partners. It would also be necessary to find ways to stimulate the appetite of potential investors and investees; neither of whom has a strong culture or tradition of partnering with the other.

An important development in this discussion is the recent announcement that HM Treasury, the Bank of England and the FCA will convene an industry working group to facilitate investment in 'productive finance'. Productive finance is defined as investment that expands productive capacity and advances sustainable growth. Examples include infrastructure, research and development, capital investment in new equipment (e.g. a manufacturer investing in a new production line) and embedding advanced technologies.

It can therefore be viewed as a new and bespoke form of equity investment that requires investors to demonstrate patience as returns can only be realised over the longer-term. This work has begun in Scotland with the development of an innovative and new financial instrument which might be applicable to traditional industries. There is a further suggestion that the group's work will consider how such investment could be made available at tiers of the economy normally considered unsuited to equity; strongly aligning to the Scottish context that I have just described. My advice is that this is a positive development which the Scottish Government should support: a culture of patient, long-term investment that injects capital for sustainable growth aligns closely to the needs and profile of the Scottish economy, the missions of SNIB and the Scottish Government's wider economic ambitions.

There are also more immediate economic reasons why Scotland should support the growth of this investment model. Scotland possesses genuinely world class capability in the field of long-term asset management; often managing precisely the pools of capital that are best suited to patient investment. The Scottish industry is therefore ideally placed both to shape and benefit from such initiatives.

Recommendation 5: The Scottish Government should seek to influence the membership and work plan of the UK Productive Finance Taskforce, making clear our world-class capability in this field and ensuring that it produces solutions beneficial to the Scottish economy.

The Scottish asset management industry and the SNIB should collaborate to explore the possibility of creating Scottish patient equity instruments, tailored to the needs and profile of Scottish SMEs.

3. Equity for emerging, high growth industries

The early response to the pandemic has correctly focussed on economic resilience for the protection of businesses and livelihoods. But as focus turns towards longer-term recovery, it is crucial that we maximise the potential of Scotland's emerging economic strengths to generate growth and job creation. Promising sectors such as fintech, life sciences, space, green and digital technologies should be central to our economic future.

Since the onset of the pandemic, the Scottish Government has put in place strong new policy foundations. Mark Logan's Scottish Technology Ecosystem Review (STER) offers a compelling blueprint to establish Scotland as a world-class tech hub. The new inward investment strategy is similarly promising and will modernise international perceptions of the Scottish economy through its prioritisation of emerging, innovative and knowledge-intensive sectors. This advice will not repeat the analysis offered in those publications. Instead, in line with my remit to focus on *financing* recovery, I will focus on providing Ministers with a more detailed treatment of how these policy interventions can be complemented by addressing strategic gaps in Scotland's high growth investment market.

In this section I explain the main types of high growth equity before exploring the characteristics of the Scottish market and the impact that the pandemic may have on it. I close by echoing STER's analysis that despite the overall strength of the Scottish investment scene, it suffers from a lack of private venture capital investment which restricts our potential as a first rate start-up nation.

High growth equity: an overview

High growth equity is a specialist form of finance designed to meet the needs of young, innovative companies which are pursuing high growth opportunities. Usually, they are pre-revenue or have minimal sales as they develop their product and achieve market traction. This lack of collateral and negative cash flow means they are unable to access traditional bank lending to finance their growth ambitions. Equity investment fills this gap by investing on a medium to long term basis in exchange for a share in the company. As STER makes clear, a healthy and diverse equity market is critical to a thriving entrepreneurial ecosystem.

Table 2: STER comparison between mature and immature investment markets

Characteristics of Mature Investment Markets	Characteristics of Immature Markets
Mostly VC capital	Mostly "angel" capital
Full range of investments from small to very large	Mostly small investments
High discoverability of prospects i.e. VCs actively scout companies the ecosystem 'deal flow'	Poor discoverability of prospects – many companies have to go searching for VC.
Lower friction for investors	Higher friction for investors e.g. due to geographical distance and lower density of investable prospects.
Higher pitching expertise among founders	Low pitching expertise among founders
Low-level of government funding	High-level of government funding

Source: Scottish Government, August 2020, Scottish Technology Ecosystem: Review

There are two main sources of high growth equity: business angels and venture capital funds (VCs). Business angels and VCs act as parallel funding sources and, in mature ecosystems with a diverse equity market and sufficient supply of capital, provide two different financing choices for start-up/scale-up companies:

- **Business angels and business angel syndicates** – wealthy private individuals who invest individually or come together as a group to invest their own money. Increasingly, business angels prefer to invest as part of a syndicate, reducing individual risk and increasing the expertise the syndicate can bring to their investee companies. In combination with Scottish Enterprise, business angels and business angel syndicates **dominate** investment in high growth companies in Scotland. A successful exit typically takes ten to fifteen years.

- **Venture capital funds** - professional investors who manage money raised from Governments and financial institutions, e.g. pension funds, insurance companies, endowments and banks. VC funds typically specialise by stage of business, size of investment and sometimes sector. There are few VCs active at the earliest stages due to high levels of risk, whereas risk reduces and likelihood of success increases at the later stages of investment. A successful exit for a VC typically takes five to seven years.

A key benefit of accessing equity is that it is ‘smart money’, providing expertise as well as capital: providing advice, operational support and access to networks that will help companies access markets and customers. Well informed founders will target VCs with networks and expertise relevant to their stage and sector. It is common practice for the public sector to capitalise privately operated VC funds as a means of addressing weaknesses in high growth equity markets. For example, the European Investment Fund (owned by the EU Member States, the European Commission and the European Investment Bank) is a cornerstone investor for any VC wishing to establish a fund in Europe, often providing 30% of the capital value of new funds. The British Business Bank has similar ambitions for UK-based VCs following Brexit, and is a key investor in the English regional funds, e.g. Northern Powerhouse Investment Fund.

Through the Scottish Growth Scheme (SGS), the Scottish Government has capitalised Techstart and Foresight, two privately managed equity funds focussed on new deals (as opposed to follow-on investment in existing investees) and, in the case of Foresight, on scale-up growth. These funds have been a popular new addition to Scotland’s small VC community.

Impact of coronavirus on the Scottish market

Data published by LINC, the trade body for business angels in Scotland, shows that angel investment activity almost doubled in value during H1 2020 compared with H1 2019[28]. However, most of that activity was focussed on ‘follow-on’ deals to **protect investment outlay on existing portfolios, with less focus on new deals, impacting the availability of capital for earlier stage start-ups looking for their first round of investment**[29]. There continues to be significant anecdotal evidence that companies looking to scale often need to access funding from outside Scotland, and so leave Scotland at the point where they are beginning to scale and create jobs.

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[28] LINC Scotland, July 2020, Press Release: ‘Another Strong Quarter from Business Angel Syndicates’

[29] New deals were however boosted by SG’s Early Stage Growth Scheme.

It is expected that these trends are likely to get worse, restricting access to capital for Scotland's best growth and scale companies, and limiting the options for new start-ups. Without broader equity capital, innovative businesses simply cannot survive or grow in Scotland. Since these companies are the employers of tomorrow, this jeopardising an important strand of recovery and growth.

Improving the Scottish equity market

Since this section is focused on financing recovery, I have chosen not to offer detailed commentary on either the UK Government's Future Fund or the Scottish Government's Early Stage Growth Scheme – interventions introduced to shore up investment markets in the immediate wake of the pandemic. Depending on how market trends evolve over the next 12 months, it is possible that such exercises will require to be repeated.

But in this advice I am focused on the **structural** issues in the Scottish equity market that pre-date COVID and that should be addressed over the longer term if we are serious about harnessing high growth emerging industries as a key route to recovery.

In my view, the key issue is that the Scottish equity investment market is too one-dimensional, relying to a very significant extent on business angels and SE co-investment.

To frame this in a different way, there is very little private VC activity in Scotland, with few major external players scouting Scottish start-ups and scalers, and with even domestic VCs focussing their activity on deals outwith Scotland. A number of important consequences flow from this lack of VC activity:

- **VCs fund managers offer something different that is largely unavailable in the present Scottish market.** A common misconception is that angels and VCs are part of an investment continuum or 'ladder', whereby angels pass the torch to VCs as the need for scale-up funding grows. The reality is that this is fairly uncommon. Indeed, a company with investment from an angel syndicate will sometimes find that disincentivises VCs who can view this ownership model as overly complex. VC funds often specialise in particular sectors or forms of technology, and will invest much larger amounts per funding round than business angel syndicates. Many have exceptional experience of advising and developing companies to scale and successful exits. For Scottish companies for whom VC funding is the correct model, the imbalance in the Scottish marketplace is a significant disadvantage.

- **Informed Scottish companies more suited to VC than angel investment will therefore look beyond Scotland to find it.** Scottish businesses *do* access VC funding but they usually have to leave Scotland to find it. Developing a relationship with e.g. a London or Paris based VC increases the risk that our best high growth and scaling start-ups will be enticed to join larger ecosystems. There is anecdotal evidence that this is already a feature of the Scottish ecosystem e.g. in preparing this advice we were informed of some life sciences businesses relocating to America in order to access informed VCs with links to an enormous market.

- **Wider expertise coalesces around a varied and competitive capital environment.** As STER makes clear, the best entrepreneurial ecosystems turn on the availability of talent, capital and infrastructure. Having more diverse sources of capital will attract the attention of other investors, entrepreneurs, corporates looking to acquire innovative companies and the wider community of advisors and prestigious private accelerators who can direct clients towards emerging ecosystems. A more diverse investment market, combined with the world-class support for companies proposed in STER would make Scotland an attractive hub for entrepreneurship and investment.

What we should be seeking to create in Scotland is therefore a virtuous circle in which a stronger pipeline better quality start-ups (which can be delivered through STER implementation) attracts a higher density and diversity of capital; with this vibrant capital market in turn attracting new talent and investment.

Recommendation 6: Drawing on the advice and support of industry, the Scottish Government, SE and SNIB should seek to facilitate the diversification and density of Scotland's high growth investment market. This can be achieved pro-actively establishing relationships with key VCs, showcasing the best Scottish talent and potentially providing incentives such as capitalising privately managed VC funds with a remit to invest in Scottish companies.

4. Green Finance

From the early stages of the pandemic, Scottish Ministers have emphasised the importance of making economic recovery green. Ensuring Scottish businesses can access sufficient and appropriate finance to support them not only to recover but help them progress towards net zero will be critical if we are to end Scotland's contribution to climate change by 2045, and to seize the wider opportunities of the low carbon economy.

2021 is an important year for the economy and the climate, with November's COP26 in Glasgow the focal point. Green finance is a major theme of the UK Presidency, and the UK Government is planning significant interventions to establish the UK as the premier global centre for sustainable investment. Scotland's finance and business sectors will need to be prepared for these changes, but they also represent a major opportunity for Scotland to capitalise on the spotlight COP26 will cast on our climate credentials and to attract new investment in our recovery and future economy.

Green finance in Scotland

Scotland has committed to reaching net zero carbon emissions by 2045, five years earlier than the UK as a whole. The economic and social transformation required to achieve it will be enormous, but Scotland's strengths – including in access to renewable energy and natural carbon sinks such as peatland and woodland – mean there are also significant opportunities.

Securing the requisite finance for green projects has historically been challenging, and the public sector has often had to provide incentives through subsidies, price guarantees or regulation to provide certainty of returns. Given the scale of the investment required to reach net zero, this cannot be sustained in the long run.

Technological improvements, combined with a global movement to significantly reduce emissions, is beginning to change this – for example, the decline in the costs of funding offshore wind projects in the UK has contributed to new contracts likely becoming subsidy free by 2023. The growing momentum behind reducing emissions has made investing in combatting climate change more attractive, particularly through Environment, Social and Governance (ESG) investment vehicles[30].

This year, ESG-focused funds broke through $1 trillion in assets under management. Despite still being a relatively small segment of the market the direction of travel is clear, and has even seen acceleration during the pandemic. In the UK as a whole, more new money was invested in ESG funds in the second quarter of this year than in the previous five years combined, and global estimates show flows into ESG funds comprising between a third and half of all global fund sales over the past year.

As technologies and markets mature, green investments will become increasingly mainstream, bringing even more capital into scope.

To ensure Scotland is taking advantage of the finance that is available, we will need to better understand the market conditions and barriers to investment that Scottish businesses and projects face. Learning from initiatives like the Green Investment Portfolio – which launched in September, and identifies low carbon propositions and markets them to international investors – and the newly established Scottish National Investment Bank, will be important for identifying ways to get as much of this capital flowing into Scotland, and supporting a green recovery, as possible.

Scotland is not alone in looking to expand access to green finance. In November 2020, the UK Government made several significant announcements designed to demonstrate regulatory and policy leadership, as well as solidify London's position as the leading global centre for green finance. Though light on details, the policies – announced as part of a "Future of Financial Services" statement – are wide-ranging and have potentially significant impacts for Scottish businesses and financial companies.

The Treasury and major regulators released a roadmap for making climate-related financial disclosures (referred to as 'the TCFD[31] recommendations' for shorthand) which sets out mandatory requirements to be applied across the UK economy by 2025 at the latest, with many large firms required to comply from 2021. Requiring more comprehensive climate-related disclosures will allow investors to better price these risks, which in turn should drive investment towards more sustainable projects. This provides opportunities for Scottish firms, but may also impact existing businesses' access to capital if they are less net zero aligned.

[30] Investment funds which invest only in businesses and industries which meet pre-defined ethical and environmental criteria.

[31] The Taskforce on Climate-related Financial Disclosures (TCFD) is an international body that was tasked by the Financial Stability Board to recommend a set of common disclosure standards for the financial sector and major NFCs. The recommendations were published in 2017, and focused on governance, strategy, risk management, and metrics and targets.

This is likely to be complemented by a new UK 'green taxonomy' which will classify investments according to their compliance with the net zero objective.
The taxonomy will be largely based on the version agreed by the EU in 2019, though there may be divergence in some areas. The objective again is to tilt the investment landscape away from 'brown' to 'green' investments by increasing transparency.

The UK Government also announced that it would issue its first green sovereign bond in 2021, with the intention of building a 'green yield curve' over the coming years. While corporate green bonds have existed for some time, the development of a sterling-denominated 'green safe asset' could act as a significant boost to market liquidity and create opportunities for Scottish firms that are able to issue green bonds.

The Opportunity

The momentum that is building behind green finance is a very significant economic opportunity for the future of Scottish financial services. We are already a global centre for active fund management and, with the correct positioning, this shift to green has the potential to significantly grow our domestic capability and attract new inward investment.

Together with our natural assets; political commitment to green recovery; world-class research capabilities and an emerging green technology sector, Scotland has all of the necessary ingredients to reap the economic benefits of the shift to green. It is essential that these opportunities are realised.

Hosting COP26 in Glasgow next year will be an important opportunity to showcase Scotland's credentials as a green finance hub, as well as an attractive destination for green investment.

Major public spending announcements – such as the £1.6bn invested into decarbonising heat and buildings, the creation of SNIB and the implementation of STER to transform the environment for early stage businesses – can all be leveraged to this end.

Recommendation 7: The Scottish Government, Scottish Financial Enterprise and SNIB should work together much more closely to develop a plan to use COP26 to showcase Scotland as a hub for green finance, technologies and investment.

Part 4: Beyond Finance – Business Support and Collaboration

1. Introduction

As I have stressed throughout this advice, it is difficult to over-estimate the profound challenges that businesses will face over the next 12-18 months between debt repayment, the pace or otherwise of economic recovery, EU exit and potentially permanent changes in working culture and consumer behaviour. A key objective for banks and for the public sector must therefore be to support businesses, beyond the purely financial, through a period of transition and unprecedented strategic challenge.

While my principal remit was to advise Ministers on financing recovery, it has been difficult to avoid discussions and engagement straying into this wider territory. I have therefore chosen to offer this final, brief section offering the key conclusions from those discussions on topics ranging from collaboration with industry to business support and the need to remember the importance of 'old' challenges as we move into a new era. This material is far from an exhaustive treatment of these issues and may therefore be considered best as a short addendum to the related themes addressed in the original AGER report.

2. Engagement with industry

As the original AGER report made clear, it is critical that Government arms itself with the deepest possible understanding of the challenges faced by sectors and businesses both large and small. This will require new and more effective models of collaboration and a pro-active effort to listen to industry in designing future interventions.

It is for Government to co-design those models with the industries concerned and for that reason I have decided not to make additional recommendations here. The important thing is that this engagement takes place.

Due to the membership of the group that supported the development of this advice, I make an exception to this rule in the case of financial services. The pandemic has led to the financial services industry and the Scottish Government working more closely than ever before: sharing intelligence, developing policy and collaborating for the benefit of citizens e.g. through the system established during the summer to escalate individual cases to senior executive level in key banks. Both parties are in agreement that this partnership is valuable and should be deepened as we enter a new, but perhaps even more challenging phase.

The time is therefore right to consider whether we have optimal engagement structures in place. While this should be discussed further between Ministers and SFE, I suggest a three-fold approach:

- Monthly discussions between the Cabinet Secretary for Economy, Fair Work and Culture, and the Chair and Chief Executive of SFE. These discussions should centre on insights yielded from the Banking Barometer, the health of the financial services industry in Scotland and any emerging issues. These discussions will be supplemented by the regular cycle of conversations between officials and industry.
- Quarterly Meetings of FISAB**.** I suggest that the existing focus on the growth and development of the Scottish financial services industry should be maintained. However the membership should be refreshed and potentially reduced to achieve focus and participation. SFE and officials should work together to produce advice for Ministers on how the work of FISAB could be placed on a more strategic footing, ensuring that meetings are impactful and result in meaningful actions which advance the shared priorities of Ministers and industry. FISAB could, for example, develop and progress several of the recommendations in this advice.
- The Banking and Economy Forum in its current form should be disbanded**.** Its membership and purpose are similar to FISAB sometimes causing confusion and diluting the impact and strategic value of both groups. In its place SFE should convene a much smaller group of senior industry figures to meet with the Cabinet Secretary on a quarterly basis. This would act as a forum for frank discussion, the discreet testing of policy ideas and for Ministers to commission and receive the economic advice of industry. It could be used to identify future priorities for FISAB and to initiate more bespoke advice or projects where necessary.

3. A new 'Banking Barometer'

Since the onset of the pandemic, the Scottish banking sector has recognised the importance of supporting Scottish Ministers by more effectively harnessing the sector's unique access to real-time economic insight. I am pleased to report that seven banks[32] have agreed to participate in a monthly survey. The results of this survey will be aggregated, anonymised and presented in a monthly report to Scottish Government Ministers.

The report will provide key real-time metrics, including:

- Lending trends
- Access and usage of working capital facilities
- Finance repayment trends
- Liquidity, including deposits and cash holdings
- Status of holdings linked to coronavirus loans (i.e. whether loans are being spent or retained)
- Financial stress related to EU Exit
- Sectoral and regional trends
- Appetite to invest

[32] The participating institutions are Bank of Scotland, Barclays, HSBC, RBS, Santander, TSB and Virgin Money.

- Any other emerging trends

This is the first time that real-time banking insight of this kind has been aggregated and shared with Government. It should provide Ministers and officials with a powerful new tool to identify trends early and to tailor policy interventions accordingly. This is a considerable achievement which demonstrates the sector's appetite to work in partnership with the Scottish Government to support recovery.

4. Improving business advice

It is worth reinforcing that Scottish businesses, especially in sectors such as retail and hospitality, often have very small management teams. As a consequence, even prior to the pandemic, such businesses have little strategic capacity to plot a course towards growth that successfully navigates all of the challenges they currently face.

To provide an example, there is anecdotal evidence that applications for both public and private sector support packages routinely demonstrated a basic lack of expertise in accounting, forecasting and business planning. More than ever, the focus for these businesses will be on pure survival and that approach, writ large across the economy, risks stifling recovery.

For all of these reasons, there has never been a better time to improve the quality, accessibility and intensity of advice and support for businesses.

While I recognise that a great deal of this already exists across the public and private sectors; the feedback from businesses is that it can be passive, patchy, confusing to navigate, too generic to be useful and often misses critical topics where more intensive, personalised support and expertise is required.

Small retailers flagged the example of being frequently advised to invest in e-commerce but with little guidance about the most effective platforms for their market nor where to access credible products or expert consultancy.
Other businesses highlighted that SE's specialist teams (e.g. on digital and financial readiness) are of significant value, but that these services operate on a limited scale. In relation to the private sector, businesses without relationship managers spoke of having a purely transactional relationships with their bank notwithstanding the availability online resources and training. The public and private sectors must listen to these concerns and combine their resources to democratise access to quality business support.

Recommendation 8: The banks, enterprise agencies and business organisations should collaborate to improve the quality and accessibility of business support. It is essential that this is co-designed with businesses, ensuring that their needs are met. From our engagement, I suggest that the following areas are worthy of consideration:

- **A clear outline of public sector financial support.**
- **Restructuring and diversifying to maintain productive capacity.**
- **Business planning, debt management and cash flow forecasting.**
- **Expansion of pro-active, specialist support for acutely impacted sectors and businesses.**

- **Accessing capital for resilience and growth.**

5. Growing through connections - strategic facilitation of new trading relationships

Scotland is a small country with a relatively few key economic institutions and networks. It should be possible to better leverage this to our strategic advantage through more pro-active sharing of intelligence and networks to facilitate businesses' access to new funding, partners and markets.

The key business organisations, the banks and enterprise agency relationship managers have close, personal knowledge of many thousands of businesses across Scotland. While being mindful of the ethics around breaching confidentiality and competition rules, and the risks of attempting to over-engineer the economy, we should explore whether it is possible to somehow pool this knowledge to make new connections that can drive value for the economy. It should be noted that strategic facilitation of this kind has proved successful in the Scottish Government's work over the summer to establish new domestic supply chains to support the NHS.

This principle of realising new economic value simply through more intelligent, pro-active customer management can be extended to a range of other circumstances.

For example, in the post-pandemic economy there are likely to be occasions where businesses operating in the same sector and/or locality would increase their resilience and growth capacity by considering a merger or acquisition. Where permission is granted by businesses to act on this information it may be possible to connect them to suitable and willing partners for discussion. This is relatively simple, high impact work capable of preserving businesses and jobs.

Recommendation 9: The Scottish Government should convene the enterprise agencies, business organisations and the banks to explore whether is a way to work across organisations, pooling intelligence and networks to make the strategic connections necessary to facilitate new contracts, business relationships and access to markets.

6. Solving old problems for a new economy

As we have seen, the success of the post-pandemic economy will rest, to a significant extent, on how effectively the business base, with the support of banks and Government, is able to balance the tension between managing coronavirus debt burden and proving access to new capital for growth, innovation and productivity. It is therefore right that much of recovery planning, including this advice, has principally focussed on issues relating to finance and capital. But we should not forget that the economy has for many years been characterised by another set of challenges which have also limited growth, productivity and job creation. Those challenges have not gone away. Indeed their impact will be amplified by a new economic reality and the stretched capacity of SMEs to cope with that reality.

As Government turns its mind to the planning of longer term economic strategy, it is important that these 'old' economic challenges are given the attention and prominence that they deserve – they are more critical than ever to realising

Scotland's economic potential. In this section I draw out some of these key issues, all of which will be familiar to Ministers, and recommend that they figure in the future planning of pandemic-related business support.

Innovation and new technologies

The pandemic has underlined the economic importance of digital capability and wider technological integration. The businesses that have coped best are those who have been able to innovate: pivoting quickly to homeworking, adopting cloud computing for speed and collaborative working, diversifying products and services and using digital platforms to access new markets.

Despite this progress**,** the overall evidence is that Scotland's SME base has a poor record of adopting new technologies. Despite comparable connectivity and digital infrastructure to similarly advanced EU nations, our SMEs perform poorly on usage compared with top performing countries (e.g. trailing Denmark by a substantial across several key categories identified by the EU).

The latest Scottish Digital Economy Maturity Index found that only 7% of Scottish businesses (often either large corporates or young and innovative firms) were maximising the use of digital technologies while 76% either did not use digital technology at all or did so only at a relatively basic level[33].

This has a significant economic cost. On a practical level, it means we will fail to maximise the value derived from increased investment in digital infrastructure (as recommended in the AGER report).
More positively, OECD research has consistently found that investment in technology boosts growth, productivity, economic inclusion and the creation of high value jobs.

It is also an effective means of tackling regional income equality, preventing city-based 'frontier' firms racing away from community-based SMEs. Recent action by the Scottish Government to increase investment in the digitalisation of SMEs represents welcome progress. However, I understand this investment expires at the end of the financial year.

Leadership and management capacity

There is equally strong evidence that many of the challenges facing the Scottish economy are rooted in the limited management and strategic capacity in our already stretched SME base. In many industries these challenges will be exacerbated by a potentially permanent shift to home working, posing new challenges for the development and integration of innovative, high performance operating models.

In some ways this challenge is ironic since several of our universities operate management schools of international distinction. In this time of unprecedented challenge, this is a national asset that must be deployed for greater impact on the economy. These issues have previously been highlighted by the Enterprise and

[33] Scottish Government, March 2018, Scotland's Digital Economy Maturity Index 2017

Skills Board; but an effective solution which operates at scale does not appear to be in place.

Diffusion of best practice

The Chief Economist to the Bank of England, Andy Haldane, has argued that one of the principal reasons for the UK's sluggish productivity is its failure to establish effective mechanisms for the diffusion of best practice from highly productive 'frontier firms' to the wider SME base. His arguments are well-founded: OECD research has consistently highlighted the spill over effects of firms learning and mirroring the practises of more advanced supply chain partners, customers and competitors. Policy initiatives across Europe have further shown that establishing mechanisms for peer-to-peer support and collaboration is an especially effective mechanism for delivering such diffusion.

In Scotland, we understand that a pilot programme for 'Productivity Clubs' has shown promise but it is clear that there remains plenty of scope for the development and expansion of this and other policy initiatives.

Recommendation 10: The Scottish Government should take account of these cross-cutting issues in planning any future financial support packages and in designing an improved business support offer in line with recommendation 8. Particular actions worth considering may include:

- **Working with universities and business to establish effective diffusion networks; learning from best international practice.**
- **Incentivising SMEs to adopt new technologies and innovation e.g. through grants to co-fund costs.**
- **Following the lead of other countries in producing pre-designed 'off-the-shelf' packages combining technology, advice and training packages tailored to the needs of businesses in particular sectors and of different sizes. This could include common but impactful themes like e-commerce; cloud computing; use of data and online trading platforms.**
- **Complementing this offer with similarly packaged 'off the shelf' management and operating model solutions, with accompanying access to training and the option to embed specialist graduates for a fixed term to support implementation (programmes of this kind already exist but on a limited scale).**
- **Subsidising the cost of buying-in specialist skills or training to implement solutions of the kind noted.**

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