THE INCLUSIVE GROWTH COMMISSION

Financial Capital

2nd report of the Inclusive Growth Commission

March 2024

BRADSHAW ADVISORY

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Executive summary 01

Supporters of inclusive growth argue that economic outcomes and societal outcomes are intrinsically linked. As such, addressing issues such as the gender pay gap, educational inequality, regional growth differences and environmental harm need to be part of the debate around how to best solve the UK's growth problem.

Within this context, the IGC defines inclusive growth as giving more people and places the opportunity to contribute to and benefit from economic progress. Financial capital can contribute to these opportunities being delivered and sustained by being:

- **Productivity-focused.** Ensuring that businesses can access the finance they need to fund infrastructure and innovation.
- **Partnership-based.** Ensuring that the government provides a regulatory environment that is conducive to the deployment of financial capital.
- **Long-termist.** Ensuring that there are the right incentives to encourage patient capital.

Diagnosis

There are two types of investment financing which warrant policy intervention:

1. **Infrastructure finance** – debt or equity funding for physical capital like transport, energy and housing. Here, the pools of capital are more readily available as once deployed the assets can and do offer stable returns, but minimum capital commitments are very large, investments face delivery risk and heterogeneity of asset class means it can be difficult to find appropriate projects. **The problems are:**

   a. Vast requirements in a challenging fiscal environment.
   b. Delivery risk – including planning – can be very costly.
   c. Heterogeneity of the asset class means that finding an appropriate project is not easy even for large, sophisticated investors.

2. **Innovation finance** – debt or equity funding for early-stage companies with a novel business model, technology or product. Here, the pools of capital are less readily available as investments are extremely uncertain, investment expertise is costly but capital commitments are not as large and this type of investment will be increasingly important from an economy-wide perspective. **The problems are:**

   a. Challenging investment proposition to non-specialist investors due to inherently speculative nature of the business, as first established by the 2017 Patient Capital Review.
   b. Frequently, especially in the technology sector, the firms do not own assets that can be easily used to secure loans.

Recommendations 02

Infrastructure

Office for Investment (OfI) should have a clearer domestic role in finding, promoting and matching appropriate projects and opportunities to UK long-term investors, working with the UK Infrastructure Bank (UKIB) and other relevant stakeholders.

- **Why:** Due to the heterogeneity of infrastructure as an asset class, finding projects with appropriate risk-return profiles, ticket sizes and/or liquidity needs can be challenging, and therefore costly. More generally, for reasons ranging from downstream issues around planning to the UK lacking a reliable pipeline of investment propositions around which investors can build a strategy.

- **How:** Office for Investment acts as an "investment matchmaker" for pools of foreign capital, but some of those same problems apply to domestic investors. Its role should therefore be expanded to the latter, and include updating the UK Trade & Investment Infrastructure Pitchbook, entering into a Memorandum of Understanding with the UKIB to jointly line up long-term investors and shape projects to suit pools of available capital, and consider more formalised investment partnerships like the ones Office for Investment (OfI) strikes with large foreign investors.

UK Infrastructure Bank's advisory function could be crucial to UK project pipeline development if it works in tandem with domestic long-term investors, potentially through the OfI. HM Treasury should also ensure its mandate is sufficiently long-termist, by being more clear on dividend expectations and support beyond five years given lengthy project timelines.

- **Why:** The relatively high multiplier on the amount of private capital crowded in suggests the institution does not struggle with attracting private capital, but the Bank deployed only 10% of its capacity within two years, when the annual capacity deployment limit has been set by statute at £5.5 billion, i.e, around 25% of capacity. It is understandable that building up staffing to full operational capacity takes time.[1] However, this could be indicative of a general difficulty in building a reliable, investable UK infrastructure pipeline.

- **How:** It should regularly engage with long-term capital representatives, for example through the Investment Delivery Forum and/or Office for Investment in its proposed domestic capacity, to line up, shape and match the financing profile of projects to appropriate long-term pools of capital, emphasising parameters like stability of income and very long-term investment horizons. Additionally, HM Treasury should give UKIB clarity on the terms on which it would draw dividends, in such a way so as to not prevent the institution reaching critical scale, and consider extending the five year term for profitability given the Bank itself regards it as difficult if it is to refinance solely from own investments.

New financing/risk-sharing models drawing appropriate lessons from failures of PPPs should continue to be developed.

- **Why:** In the case of large, complex infrastructure projects that need to be financed by more than one investor – especially in still-emerging fields like renewables – different stages and aspects of the project with differing levels of risk will need to be financed differently, according to differing needs of investors.

- **How:** The Government could announce the infrastructure equivalent of the LIFTs scheme – Long-term Investment for Infrastructure (LIFI) – and challenge industry stakeholders to put forward proposals. It could draw inspiration from existing examples of novel financing, for example from IFM Investors' Build Australia model of equity partnership from the start, exposure to the build stage of renewables through investment grade bonds as with the Walney expansion or partnership with local authorities or other bodies able to utilise new powers under the Subsidy Control Act 2022 to provide risk capital.

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Innovation

Collateralising IP: As part of the ambition for the UK to become a 'Science Superpower', the Office for IP should work with relevant stakeholders to make it easier for capital-light, intangible-intensive firms to raise capital.

- **Why:** Important because intangible capital like IP is making up more and more of total capital stock, but it's difficult to borrow against it due to, amongst other things, lack of secondary markets, which means these companies struggle with access to capital.
- **How:** For example, it could work with major lenders to understand how to take into account IP in lenders' internal risk models, and learn from markets like Singapore and Korea. The UK is well-placed to become a global leader if bandwidth and resources are dedicated to it, due to its unique combination of finance and basic science expertise.

Co-investment alongside Government-linked vehicles like British Patient Capital (BPC).

- **Why:** BPC establishing the Growth Fund and other co-investment initiatives aimed at the pensions industry at the 2023 Autumn Statement is a welcome step, but changing the culture of the industry focused on costs over value and long-term returns will be extremely difficult, not least because it's driven in significant part by pension Auto-Enrolment market dynamics.
- **How:** The Government could encourage investment by waiving part or all of the management fee and charging performance fees only for a set period of time. This would remove much of the risk associated with this type of investment and work within the grain of the pension market realities in the expectation that once value is proved, the incentives could be removed.

Market capacity

Sharing scale and expertise: Role for the Pension Protection Fund role for Defined Benefit (DB) pension schemes with no prospect of insurance buyout.

- **Why:** Fragmented nature of the UK pension landscape means high degree of variability in how well schemes are managed. Higher interest rates mean this year alone insurers predict £80bn in bulk annuity transactions, meaning more assets insured under Solvency UK, but a significant number have no realistic prospect of insurance buyout.
- **How:** Where there are pockets of excellence in administration and investment management in the DB landscape - such as the Pension Protection Fund - to open up its investment opportunities and advice to schemes that are not directly managed as part of their portfolio.

An introduction to inclusive growth

03

In the last 20 years, the idea of 'inclusive growth' has gained prominence across the world. Influential international organisations such as the United Nations, World Bank and OECD are all advocates. As are many local councils, businesses, regulators, industry bodies, think tanks and academics in the UK.

Proponents of inclusive growth argue that an economic model that focuses only on achieving higher growth ignores the fact that many people and places do not benefit from that growth - they do not have access to more opportunity and their living standards are stagnant.

Instead, a specific policy programme to broaden the base of those contributing to and benefiting from growth will strengthen the economy and society. For example, train more people to a higher qualification level that can be used in thriving sectors and they can then earn higher wages and businesses can access more skilled labour.

In short, making a conscious effort to include the excluded will make us all better-off.

The argument that growth could and should be more inclusive is not controversial - some may have gripes with the language used to describe it, but efforts to get more people to have a meaningful stake in the economy is regarded as fundamentally a good thing to do.

Yet there are two factors that prevent inclusive growth from developing beyond rhetoric and into a coherent policy platform:

- **Different policy opinions.** There are a wide variety of views on how growth and inclusivity can be achieved (and precisely what outcomes need to be achieved).
- **Becoming a catch-all term.** Subjects that have been associated with inclusive growth range from wealth inequality to environmental harm, and from the gender pay gap to housing availability.

But there is a clear opportunity to navigate these issues and for inclusive growth to be a central plank of a new government's approach to economic policy.

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The role of the Inclusive Growth Commission

04

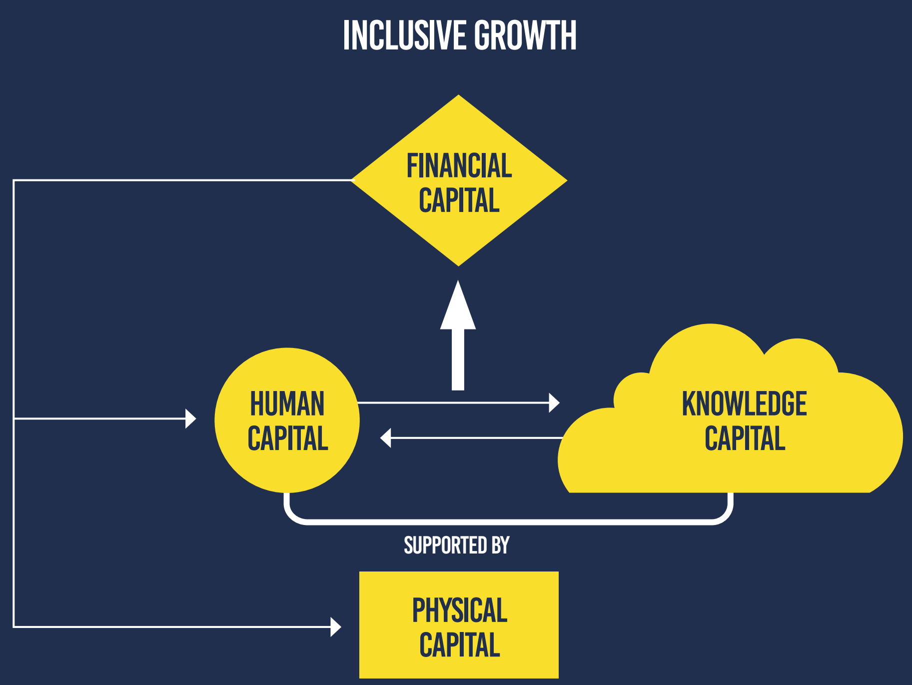
The Inclusive Growth Commission (IGC) has been established because the UK economy has lost its way at the same time that the inclusive growth agenda has lost its way. The Commission's starting point is that:

1. **The UK has a growth problem.** Over the 15 years prior to the financial crisis in 2008, the UK economy grew by around 50%. Over the 15 years following the financial crisis the UK economy only grew by around 20%.

2. **The UK has an inclusivity problem.** Of the top ten council areas for economic output per job in 2002, seven were still in the top ten for economic output per job in 2021 (City of London, Tower Hamlets, Runnymede, Slough, Westminster, Hounslow and Three Rivers). Six of these seven were in London or the South East (with Three Rivers being in the East of England).

The IGC's commissioners have experienced these problems first-hand as:

- **Deliverers** of growth.
- **Leaders** in the adoption of new technologies.
- **Difference makers** in communities across the country.



Within this context, the IGC defines inclusive growth as:

"GIVING MORE PEOPLE AND PLACES THE OPPORTUNITY TO CONTRIBUTE TO AND BENEFIT FROM ECONOMIC PROGRESS".

This definition speaks to two ideas. First, the ultimate objective of inclusivity relates to improving people's lives, but the local institutions and unique characteristics of different places create the environment for this improvement to happen. Second, that contributing to growth is recognised as being as important as benefiting from growth, i.e. inclusivity should not simply be about post-growth redistribution.

Financial capital as a driver of inclusive growth

05

The problems preventing the UK from delivering inclusive growth on the IGC's definition are well-known. It is the inability to design a package of solutions and deliver them that is the barrier to progress. This report focuses on solving the UK's lack of competitiveness when it comes to delivering financial capital.

These ideas have been designed to meet the following criteria:

- **Productivity-focused.** Recognising that raising productivity is ultimately the route to higher growth. Ensuring that more financial capital is available to fund new infrastructure (such as increasing the market capacity of UK pension funds) or to undertake innovative activity (such as reforming the role of the Office for IP) will mean more people and places can contribute to and benefit from growth.

- **Partnership-based.** Recognising that the public and private sectors – and different tiers of Government – need to work together effectively to deliver meaningful change. Public / private financing happens all the time in the UK economy, from the underwriting of small business loans provided by banks to match-funding private finance for large-scale projects. Ideas to pursue the next generation of risk-sharing models will mean communities across the country benefiting from growth-enhancing projects.

- **Long-termist.** Recognising that some growth-enhancing activity is blocked because of short-term vested-interests, political considerations or inadequate policy. For instance, the longstanding lack of financial support in the form of patient capital to support scale-up businesses in the UK. Ensuring that more long-term projects get the go-ahead - e.g. by expanding the role of the OFI - will mean that future generations will benefit from more growth infrastructure.

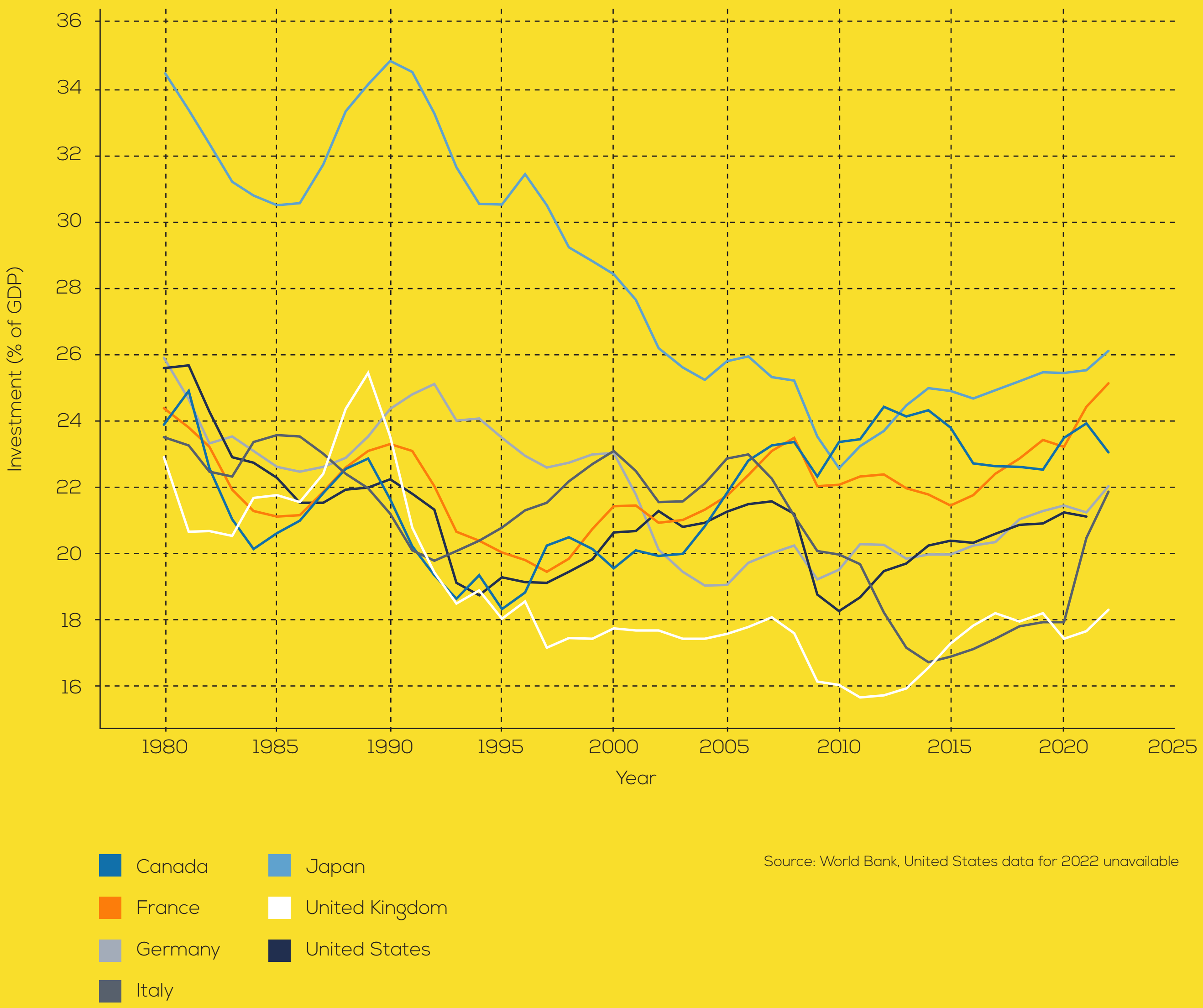
It is this criteria that will guide all of the IGC's proposals.

Picture of the UK's financial capital gap

06

Since the days of frequently being referred to as a "puzzle"[2], there is now widespread consensus that the issue of persistently low productivity and economic growth is closely linked to – alongside other issues like planning, skills, over centralisation, poor connectivity – relatively low public and private investment in the UK.

Figure 1: Investment % GDP, 1980-2022

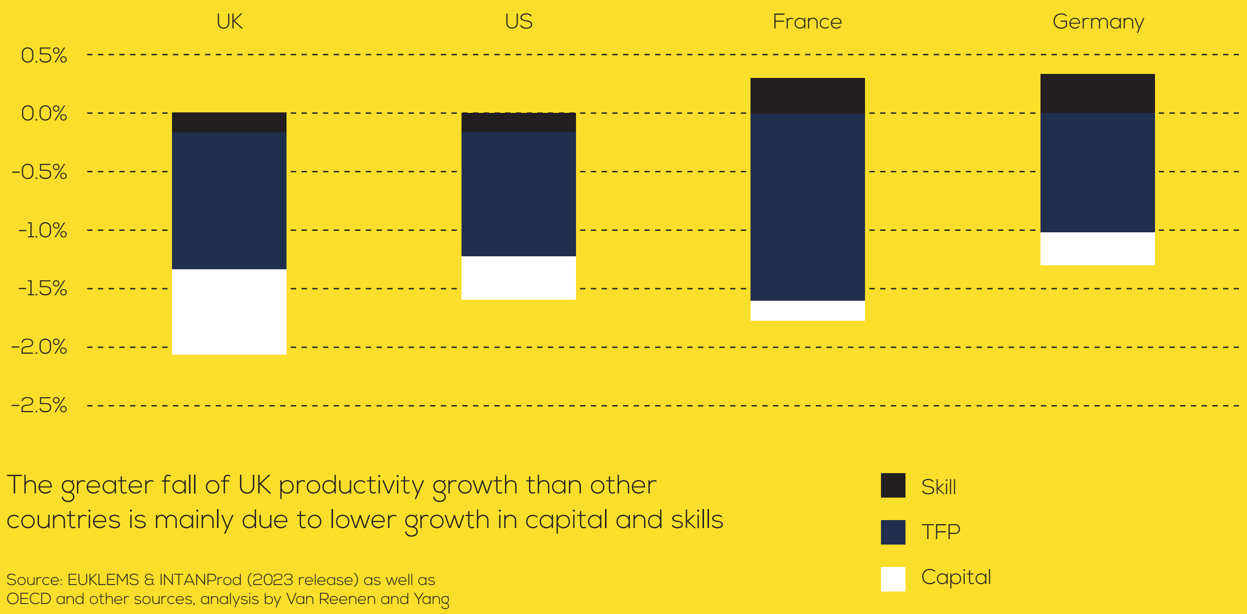


Source: World Bank, United States data for 2022 unavailable

The UK began the early 1980s with lowest investment in the G7 as a proportion of GDP – around 20-21%, compared to 24-6% for France, Germany, Italy, Canada and the US. UK investment then grew sharply (peaking at around 25% in 1990) when the rest of the G7 it plateaued or fell in the decade. As the recession of the early 1990s hit, investment fell everywhere, but in the UK the fall was the sharpest, and instead of recovering at the end of the 1990s like most of the G7 (except Germany and Japan, who started out much higher) it fell and plateaued at around 17.5%, below the peer group by some margin.[3]

There is strong evidence that this trend is chiefly responsible for the UK's low productivity growth and economic under-performance. In what is only the most recent piece of evidence, a report published at the end of last year, LSE's Programme on Innovation and Diffusion studied the UK's economic performance relative to France, Germany and the US. The authors outline a drop in annual labour productivity growth from 2.5 in the dozen years prior to the 2008 crisis compared to 0.5 in the dozen years post. They find that just over half of the drop is explained by slower growth in total factor productivity, i.e. how much is produced per unit of labour and raw materials, which is comparable across the peer group. The remainder is due to a slowdown in capital intensity, driven in large part by the UK's lower investment rate over recent years. This slowdown was much larger in the UK than the rest of the G7, presenting strong evidence for the UK's comparative underperformance.[4]

Figure 2: Comparison of market-economy real value added per hour growth 2019-2007 vs. 2007-1995



The greater fall of UK productivity growth than other countries is mainly due to lower growth in capital and skills

Source: EUKLEMS & INTANProd (2023 release) as well as OECD and other sources, analysis by Van Reenen and Yang

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Infrastructure Finance Gap

07

Underinvestment in physical capital and infrastructure in particular, both by the public and private sector, is a huge part of the story. Capital investment in housing, energy, transport and digital infrastructure is crucial to economic growth because it allows production inputs like raw materials and manpower to be combined with ideas to generate value. The Commission's first paper on deployment of physical capital details its importance for economic growth.[5]

Estimates of the exact amounts of additional investment in physical infrastructure needed vary. estimates that the UK needs £1.3 trillion of investment by 2030 to deliver on transport, energy and housing infrastructure ambitions, of which only around half is in the pipeline, leaving a £615 billion shortfall.[6]

In its 2nd National Infrastructure Assessment, the National Infrastructure Commission (NIC) recommends investment increasing from around £55 billion per year in the 2020s to around £70-80 billion in the 2030s (between a 27% and 45% increase every year) before falling to £60-70 billion in the 2040s, although the NIC was given a specific fiscal envelope which constrains its recommendations.[7]

There is broad agreement that in a challenging fiscal environment, a significant chunk of the additional investment (in some cases, most if not all) has to be privately funded. Encouraging, crowding-in and partnering with private capital is therefore a key area for government and public policy.

It is worth pointing out that when it comes to the infrastructure financing gap, while the characteristics of the supply side of capital - investors like pension funds, etc. - matter, but so does the demand side, i.e. characteristics of projects and realities of deployment. The Commission's previous paper argued that delivering physical capital in the UK is more expensive than elsewhere, that it does not have to be that way, and outlined steps that can be taken to do so. Successfully taking those steps will decrease the size of the infrastructure finance gap by virtue of making it cheaper to deliver the necessary physical capital - i.e. this issue is 'downstream' from issues in the previous paper.

Innovation Finance Gap

08

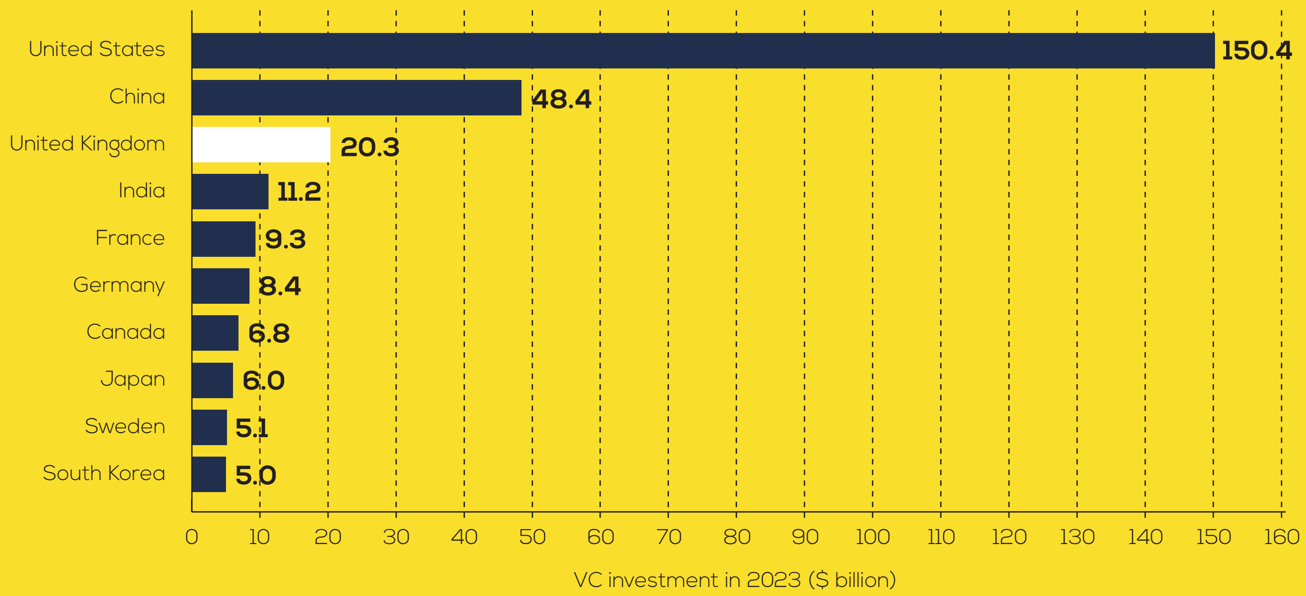
The previous section explained how capital investment affects growth. And indeed, there is evidence that the UK has also under-invested in the latter side of that equation: the ideas. More specifically, innovative, ideas-driven companies.

The subject of access to finance for small firms is not a new subject. Ever since the report of the Macmillan Committee in 1929 (largely authored by John Maynard Keynes) the 'Macmillan Gap' in the availability of finance for SMEs has been a mainstay of British public policy.[8] And while a host of policy interventions such as the creation of state-backed lending institutions (the British Business Bank, and the Capital for Enterprise initiative before it) certainly made a difference, the problem has not gone away.

In a high value-add knowledge economy like the UK, which additionally has a relatively strong basic scientific R&D base in the form of world class universities and R&D intensive firms, especially in the life sciences sector, the problem may well have been getting worse. Firms can struggle to raise debt funding due to being asset-light, i.e. most of their value comes from sources like well-educated specialist workforce, intellectual property and ideas, rather than expensive buildings, machinery and other 'tangibles' - the latter can be used to easily secure loans, the former cannot. But it is those types of firms that will be the engines of growth in a knowledge economy.

For that reason, those types of companies tend to be funded using equity capital, and in that regard the UK is, by a large margin, the best market for early stage capital in Europe, placing 3rd globally after the US and China with $21.3 billion (£16.8 billion) raised in 2023, more than double France's $9.2 billion and Germany's $8.2 billion. Of the $104 billion raised in European venture capital in the past five years, $42 billion (40%) has been raised in the UK.[9]

Figure 3: Total venture capital investment in 2023



Source: Dealbook, 2023

However, gaps still remain - for example, UK Finance has recently identified "follow on" investment as a remaining weakness, i.e. funding of the stage between start-up and scale-up.[10] It is also the case that from an economic point of view, the more of this type of funding is available to innovative companies, the lower their cost of capital, which would encourage growth in the sector. So it is not necessarily about plugging a gap, but more about creating good conditions for firms creating the products and services of tomorrow. And it should also be noted that despite the distance between the UK and its European peers, the latter are growing quickly - in 2023, UK venture capital (VC) funding grew by 19%, compared to France's 53%, Sweden's 66%.[11]

How big is this 'innovation finance' gap? A long-standing estimate by the 2017 Patient Capital Review has estimated a funding gap of £3-6 billion.[12] Performing a simple extrapolation, if the UK had the same level of venture capital investment as a percentage of GDP as the US, it would have an additional £16 billion available for innovative companies. This roughly correlates with the estimate of the Scale Up Institute, which has found a growth funding gap in the UK of £15 billion.[13]

We can therefore see that compared to the infrastructure financing gap, the innovation financing gap is much smaller in absolute terms.

Infrastructure Financing 09

Shaping an investable pipeline of projects: Domestic role for the Office for Investment

Evidence suggests there is a good supply of willing UK capital to invest in projects offering stable, inflation-linked income over 40-45 year horizons, and infrastructure in theory has this return profile. Investment Association members currently have £45 billion in UK infrastructure, and the Investment Delivery Forum - a body created by the ABI comprising some of the UK's biggest long-term investors - has pledged to invest £100 billion over the next 10 years. As investors think about their plans for the energy transition and begin to publish their net zero road maps, investment in green infrastructure necessarily forms a big part of the strategy.[14]

Although market conditions change all the time, it is also worth noting that the recent significant underperformance of the bond market - a core part of pension fund investment strategies - may not be a completely temporary phenomenon. Persistent inflation, 'higher for longer' interest rates and/or unwinding of central bank balance sheets means bonds may not be what they used to be during the rock-bottom interest rate era of the late 2010s. This will have these investors go elsewhere for stable, long-dated, inflation-linked returns. The Mansion House reform package[15] will have helped to unlock even more, as will Solvency UK when it comes into force this year.[16]

Therefore, the capital 'demand' side warrants further examination. There, evidence suggests there are at least two related but distinct problems: the issue of availability of appropriate projects with the right risk/return profile, and then, the difficulties of finding them for the investors, given these projects are competing with opportunities all over the world. Dan Mikulskis, formerly of pensions consultancy LCP, argues that mismatches in timescales between investors and industry - more specifically, between deal-making and due diligence timescales, have traditionally led to blockers.[17] He also points out that if it is true to say that there is too much money potentially chasing too few projects, or indeed looking for projects that do not exist, then extra attention must be paid to UK Infrastructure Bank not crowding out private finance.

Recommendation 1: Office for Investment (OFI) should have a domestic role in finding, promoting and matching appropriate projects and opportunities to UK long-term investors, working with the UK Infrastructure Bank and other relevant stakeholders. It could take on activities like producing a UK Infrastructure Pitchbook, something that used to be produced by UK Trade & Investment but the last edition is from 2014 - it should be updated.

Recommendation 2: OFI should sign a Memorandum of Understanding with the UK Infrastructure Bank, that in discharging its functions as an advisory body to local authorities on matters relating to development of infrastructure, the two bodies will work closely together to ensure the pipeline of forthcoming infrastructure projects fulfils the needs of long-term investors.

Recommendation 3: The Government could trial a more radical solution: exploring the possibility of OFI creating a specific investment partnership, for example modelled after the UK-UAE Sovereign Investment Partnership. However, trust law issues like fiduciary duties and not fettering discretion by trustees would have to be considered.

Shaping an investable pipeline of projects: UK Infrastructure Bank two years on

Since its founding in 2021, the UK Infrastructure Bank (UKIB) has brought the UK in line with other countries that make extensive use of public development banks, such as the KfW in Germany, NWB in the Netherlands or indeed the European Investment Bank. It has a dual role. Firstly, 'to deploy public money to solve infrastructure financing problems the private markets cannot solve on their own', through debt, equity and guarantee funding, chiefly focusing on seven areas within the space of early-stage green technology like EV charging networks, hydrogen and the carbon capture and storage. Secondly, to act as an adviser to local authorities on delivery of local infrastructure projects,[18] on issues like financing models, commercials and scaling, and sharing experiences with similar projects. It operates a mandate of £22 billion, which breaks down to £10 billion in guarantees and £12 billion is debt and equity capital capacity, of which £4 billion is specifically for local authority lending. Since beginning operations, it has to date invested £1.9 billion, which mobilised £9.7 billion in private sector capital, meaning for every £1 of public below-market financing deployed, around £5 of private investment was crowded in.[19]

As a very new institution it is too early to be definite about the degree to which it is performing. The relatively high multiplier on the amount of private capital crowded in suggests the institution does not struggle with attracting private capital. However, its commitments to date amount to deploying 10% of its capacity within two years, which seems low especially given that the annual capacity deployment limit has been set by statute at £5.5 billion, i.e, around 25% of capacity.

In its January 2023 report, the Public Accounts Committee outlined a number of (admittedly at times quite high level) concerns regarding the institution, primarily around how it intends to manage the inevitable trade offs between its twin mandate of aiding regional growth and aiding the net zero transition, how it intends to ensure "additionality", evaluate its performance and fund the advisory function.[20] It also noted that in its first two years, the Bank chose relatively conservative opportunities and did not engage in direct equity investments.

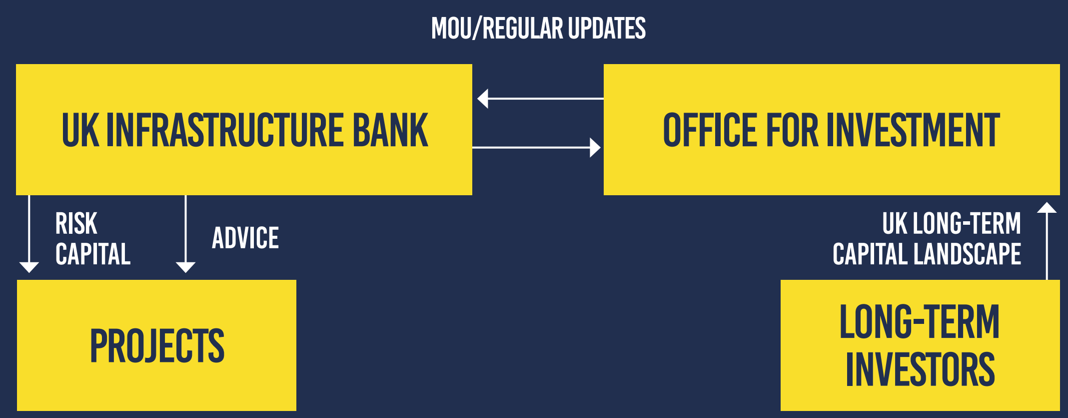
In September 2023, the Bank published a strategy update on its private sector investments and local authority advisory and lending. It set out in some detail the seven areas of focus, the range of different types of financing available, range of services under its advisory function, as well as some case studies of existing work. However, it did not substantially build on its 2022 Strategic Plan as far as its approach to evaluation, ensuring additionality, its investment principles, and - most importantly - trade offs associated with its dual mandate.

The CEO, John Flint, pointed out in a blog that before capital can be deployed on a large scale, on particularly challenging projects and through direct equity investments, staff need to be hired to deploy it, which takes time, suggesting that if UKIB seemed slow and risk averse to date, this will now change.[21] This is the reason why the Bank set itself a target of recruiting 273 permanent staff by September 2023. According to its latest accounts published 31 March 2023, it had 73.[22] It published no communications on whether it had hit that target.

As the institution finds its feet, it should consider the following:

Firstly, as mentioned in the previous section, from the perspective of long-term investors there is a dearth of investable projects, not willing capital. Both in its role as a provider of risk capital to the private sector and an adviser to local authorities on infrastructure, UKIB should have a significant degree of influence over the UK infrastructure pipeline. For this to happen, its advisory function to local authorities and other originators or projects needs to be properly resourced, and draw on the latest knowledge of the UK's long-term capital landscape, potentially working to that end with the OfI. The importance of the 'project preparation' function of national investment banks has been highlighted by the Global Infrastructure Hub - a G20 development initiative - as something frequently even more important than risk capital to mobilising private investment in infrastructure.[23]

Recommendation 4: It should regularly engage with long-term capital representatives, for example through Office for Investment in its proposed domestic capacity, to line up, shape and match the financing profile of projects to appropriate long-term pools of capital, emphasising parameters like stability of income and very long-term investment horizons. It could do this by the two institutions entering into a Memorandum of Understanding.



Secondly, it has previously been pointed out by the UCL Institute for Innovation and Public Purpose that in a last minute change, HM Treasury inserted into the framework document an ability to 'request a dividend in order to prevent significant retained earnings being accrued over time', subject to a written agreement between the two entities.[24] The latest set of UKIB accounts indicate that 'the equity instruments issued do not contain a contractual obligation to deliver cash to HM Treasury as there is no specified dividend payment schedule and the shares are non redeemable.'[25] This does not make it clear whether such an agreement (which presumably would pertain more generally than individual loans) exists, but this degree of uncertainty has the potential to hinder the UKIB's operations, and raises the possibility of political adverse incentives to 'raid' the institution for other purposes, something which frequently happens with poorly ring-fenced public financial institutions.[26]

Additionally, the Treasury expects the UKIB to be profitable within five years of launching, which means it has three years to achieve this. In its evidence to the Public Accounts Committee, the UKIB itself stated that "it expects to be profitable within five years, with its income exceeding the £70 million to £80 million a year cost of running the Bank. However, if the returns from current investments are needed to finance future deals, this would be 'more challenging' to deliver within five years."[27] Further, this requirement appears at odds with realities of infrastructure investment which frequently has maturities much longer than this, particularly in the UK where delays are extremely common, and particularly with novel technologies in the renewables space which the Bank wants to focus on as part of its Net Zero mandate. This makes sense given its emphasis on "additionality", i.e. only investing where the market is unwilling to, but potentially makes the five year target even more of a constraint.

Finally, although the Bank acknowledges trade-offs in its dual mandate, it does not go much further than that, and indeed it is arguably not its role to do so, since adjudicating between regional growth and the climate transition is a matter for the democratically elected Government. But it remains the case that ambiguity on this question risks this incredibly important institution not making much progress on either - the Government should consider clarifying.

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Recommendation 5: HM Treasury should give UKIB clarity on the terms on which it would draw dividends, in such a way so as to not prevent the institution reaching critical scale, consider whether its target of UKIB becoming profitable within 5 years has the potential to become a constraining factor, and consider whether it should be more specific on what should take priority: regional growth or Net Zero.

New financing/risk-sharing models drawing appropriate lessons from failures of PPPs should continue to be developed.

Public Private Partnerships (PPPs) like PFI/PF2 - where the upfront cost of the project and (in theory) delivery risk is moved to the private sector, while Government then provides regular payments over the life cycle of the project - have in the UK been previously beset with problems. Due to issues like poor contract negotiation, many projects ended up pushing build costs back to the private sector through fee variation clauses.

However, failures of PPP do not change the fact building infrastructure - whether tried-and-tested like rail, or very early stage like floating off-shore wind - is risky, particularly in the UK. As highlighted by the campaign group Britain Remade, deploying physical capital in the UK is very expensive relative to European peer economies, in huge part due to risks around planning delays and general high level of politicisation of development in the UK. This in turn has an effect on the risk premium developers and investors put on UK projects.

Further, in the case of large, complex infrastructure projects that need to be financed by more than one investor - especially in still-emerging fields like renewables - different stages and aspects of the project with differing levels of risk will need to be financed differently, according to differing needs of investors. Mechanisms like Regulated Asset Base (RAB) Contracts for Difference (CfD) and the Capacity Market (CM) are all designed to provide a degree of certainty to investors in projects with large upfront capital costs but where revenues are uncertain.

The focus of Mansion House reforms has been on channelling investment into early-stage innovative companies and the VC sector, but developing financing for infrastructure - although it is a more traditional asset class for long-term investors - is no less important, especially after the demise of PPPs.

Recommendation 6: The Government could announce the infrastructure equivalent of the LIFTs scheme - Long-term Investment for Infrastructure (LIFI) - and challenge industry stakeholders like the Investment Delivery Forum to put forward proposals.

The central idea behind the LIFTs initiative has been letting the private sector work out what would work best, with the Government simply backing the best idea. Since much of private under-investment in infrastructure comes down to mismatches between the needs of long-term investors and the sorts of projects on offer, it would make sense to use this mechanism again.

What do these new models might look like?

- **Equity partnership from the start:** Pioneering Australian infrastructure investors IFM recently proposed the "Build Australia" model in response to some PPP failures, which in essence stipulates that the Government should partner with an equity investor(s) from the very start on complex but promising projects,[28] which lends the Government its expertise and skin-in-the-game at the negotiating table and during operation of the project. That equity partner vehicle could raise funds from pension funds and insurers. They think the same could be done in the UK.[29]

- **Financing an equity acquisition through bonds:** For investors who require more traditional forms of exposure to infrastructure, tried and tested financing models may offer a solution. For example, Danish wind farm developer Orsted issued the UK's first investment-grade bond for the construction-stage of the extension of Walney wind farm, which was subscribed to by major life insurers like L&G and Aviva, in essence giving them exposure to the build stage of renewables but in a form that provides stable fixed income returns, and the developers capital to further develop the project pipeline.[30] This required the developer to divest 50% of the project to its two equity partners - Danish pension funds - during the build phase in a transaction worth £2 billion, of which £1.3 billion was financed by issuance of investment-grade bonds.[31]

- **Fixing investment trusts:** Although closed-ended investment trusts focusing on renewables as an asset class have been on a significant downward trajectory, they do offer a simple, established way to get exposure to infrastructure and renewables. However, as recently highlighted by Baroness Ros Altman, their falling under the remit of the Alternative Investment Fund Managers Directive (AIFMD) regulation means their costs appear artificially inflated due to double counting.[32] A Private Members Bill has been introduced to give FCA requisite powers to amend the regulations, but should it fail to make its way through Parliament, subsequent Governments should address the issue.

- **Deploying public funds as risk capital:** The Infrastructure Investment Bank has an £18bn capacity to deploy risk capital, either as bond or equity capital, or guarantees, as means of encouraging and crowding-in private capital that would otherwise not have been invested. According to its September 2023 strategy update, its financing focus is squarely on seven areas of early-stage green technology.[33] But risk capital could also productively be deployed on all types of economic infrastructure, not just the riskiest segment like green technology - local train, tram and bus networks, roads, commercial and residential buildings, digital connectivity, etc. There are examples emerging of local authorities using their subsidy capacity to provide risk capital to a wide range of development in their area, in recognition that projects which aid regional economic growth do not always neatly fit into other Government priorities. Relaxing the mandate of the UKIB so that it can have more flexibility to be an effective business partner to regional leaders should be explored.

In short, novel financing models are out there, but they require mainstreaming.

Innovation Financing

10

Going further on co-investment: changing culture through incentivising the first step

Since its establishment, the BPC has established itself as a competent, trusted investor, generating almost £500m of gains on investment since inception and a 2023 review concluding its performance is in line with private sector funds of similar age. But that same review concluded it's unclear whether it is performing its "market leadership" role especially in the context of pension funds and insurers.

Establishing the Growth Fund and other British Business Bank co-investment initiatives at the 2023 Budget was a welcome step. It is true that venture capital is a common asset class for very large, mature pension funds in the US, which is also home to the world's largest and most developed venture capital market. In the UK, although in the aggregate it is Europe's biggest pension market, it is fragmented - although there are almost £2 trillion in assets, there are only a handful of triple-digit billion schemes.

Being able to afford the high fees and investment expertise, even before the high risk of such investments is considered, becomes a problem that is partially solved by being able to invest alongside existing vehicles. Therefore, should the take up of the offer be lower than expected, there are ways to incentivise investment that would lower the risk for the inexperienced UK pension funds, but at the same time not force the Government to subsidise this investment indefinitely.

Recommendation 7: The Government could direct the investment vehicles in question to waive the management fee for a fixed period of time, during which they would charge performance fees. Alternatively, it could offer 'first loss' protection mechanisms, whereby the Government agrees to cover a fixed amount of loss, akin to a reverse insurance excess - it could base these on European Investment Bank's 'First Loss Portfolio Guarantee'.[34]

This way of incentivising investment is well-suited to institutional investors not experienced in this asset class, who are afraid of complexity and high cost - essentially, it is saying "no win, no fee". After a while, when investor expertise, trust and culture shifts, more complex fee structure can be brought in, or investors could pull out if they wish. By then, however, there will be more data on returns presenting a case either way - and hard data limits the role of factors like culture. In addition, the time limited nature of the incentive means the cost to exchequer will be strictly limited. Further, BPC remit stipulates that it has to invest on a commercial basis - however, as long as investor returns are secured, BPC as a Government-based vehicle does not have shareholders who would worry about cash flow from fees.

Banking on intangible assets: making the UK an intangible asset-backed finance pioneer

The previous policy paper from the Commission discussed in detail why both public and private investment in physical capital is important for inclusive growth.[35] However, investment in intangible capital - for example IP, software, branding, organisational capital, market research - has been steadily increasing as a share of overall investment from around 30% in 1995 to 40% in 2019 and rising.[36] According to the Global Intangible Finance Tracker, the world's intangible assets amounted to $61.9 trillion (£49.4 trillion) up 8% from $57.3 trillion (£45.6 trillion) in 2022.[37] More strikingly, recent market study found intangibles account for 90% of the value of S&P 500 firms.[38]

More importantly, there is increasingly strong evidence that investment in intangibles is closely linked to stronger productivity at firm level irrespective of sector: according to a survey conducted by McKinsey, top growing firms invested 2.6 times the amount in intangibles compared to bottom-growing firms in all sectors surveyed, with the biggest gap in financial services (5.5x) and smallest in energy and utilities (2x).[39]

Yet investment in intangibles - and for intangibles-rich firms in general - is arguably more difficult. Since items like IP, market research, software and branding are much more valuable to their originators than competitors, are difficult to value and lack secondary markets (unlike machinery and buildings - they are sunk) they cannot easily be used to secure loans and make companies intensive in them a more difficult investment and lending proposition. They also make for uncertain foundations of business models since their scalability at little cost and tendency to exhibit synergies between seemingly unrelated items mean potential for very high upside through winner-takes-all effects, network effects and high growth at little cost, but combined with potential for spillovers to be captured by competitors (who cannot be prevented from copying an idea for an app as easily as prevented from entering a factory) mean increased volatility and therefore cost of capital.[40]

Yet, the UK is better placed than most to make progress in this area. Its strength in financial services is well-known: the City of London tends to be consistently ranked 2nd overall in the Global Financial Centres Index, and performs particularly strongly on FinTech, overtaking San Francisco in that category.[41] This global strength in finance is uniquely combined with a strong basic scientific research base - the UK accounts for 13% of the top 1% of most cited scientific research and has the only Ivy League-rivalling universities in Europe. Most importantly, it is consistently ranked as having the 2nd most effective IP framework in the world.[42] The combination of these three factors forms a strong comparative advantage to make progress with intangible-backed finance in the UK.

Recommendation 8: Office for IP should work with relevant stakeholders (such as the Bank of England and the Financial Conduct Authority) to make it easier for capital-light, intangible-intensive firms to raise capital. For example, it could:

- **Trial initiatives based on similar policies from South Korea and Singapore.** In South Korea, the Korea Development Bank provides loans for IP acquisition, commercialisation and collateralisation, and also runs a Pioneer IP fund which makes direct IP investments and generates revenues from IP licensing. The Korea Credit Guarantee Fund, which facilitates intangibles-backed funding.43 In 2020, thanks to these initiatives, IP finance transactions reached 2.64 trillion KRW (approx. £16 million).44 The UK Intellectual Property Office could work with the British Business Bank to trial similar initiatives.
- **Work with major lenders to understand whether there are regulatory barriers preventing mainstreaming of IP finance.** IP finance is not completely new, but the beginning of the decade saw a number of significant developments, including $1.2 billion loan from Goldman Sachs to American Airlines secured partially by IP,45 Aon facilitating a $100 million credit facility secured by IP collaterals for Indigo using a new capital markets solution,46 and NatWest launching a new lending proposition in conjunction with IP analytics firm Inngot.47 But the market is still very new - UK Intellectual Property Office and the Bank of England should launch a regulatory review to identify barriers to progress.

If progress is to be made, it should be made quickly: South Korea has long been a leader in per capita patents, ahead of much bigger economies.[48] And now, according to the latest Global Financial Centre Index, Seoul is considered as the top financial centre prospect to watch and by a huge margin: mentioned by almost triple the number of survey respondents as Singapore, the runner up.[49]

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Box 1: IP finance in South Korea

Since 2013, South Korea has undertaken a sustained policy effort to create the right institutional environment for IP finance. Between 2018 and 2021, total IP financing volumes equalled 6.9 trillion KRW (approx. £40 million).

IP Loans

The Korea Development Bank (KDB) and the Industrial Bank of Korea (IBK) are able to provide loans of up to $2 million and $1 million respectively to IP-intensive SMEs, secured against claims on their IP. The valuation of IP is undertaken by the Korea Invention Promotion Association (KIPO). By 2020, IP-backed loans totalled 1.7 trillion KRW (approx. £10 million). In 2019, three commercial banks in Korea began offering IP-backed loans.

IP Credit Guarantees

Korea Technology Finance Corporation and the Korea Credit Guarantee Fund are able to issue credit guarantees of $1 million respectively. The IP valuation is undertaken by the Korea Investment Promotion Association in the case of Korea Credit Guarantee Fund, but the Korea Technology Finance Corporation is able to do its own valuation. By 2020, IP-guaranteed loans totalled 2.9 trillion KRW (approx. £17 million).

IP Valuation

Arguably the most important piece of the puzzle has been the establishment of the Korea Intellectual Property Valuation Centre at the Korea Invention promotion Association in 2013. It has been designated as one of technology assessment organisations by the Korean Government, and provides IP valuation services to the Korean Development Bank, Industrial Bank of Korea and the Korea Credit Guarantee Fund. It comprises scientists, technologists, patent attorneys and engineers. By taking on the cost of valuation - which in the case of IP is very high due to the need for specialised expertise which traditional lending institutions do not have - it is able to make IP-backed lending a viable proposition.

Market Capacity

Access to scale and investment expertise for the worst performing DB schemes

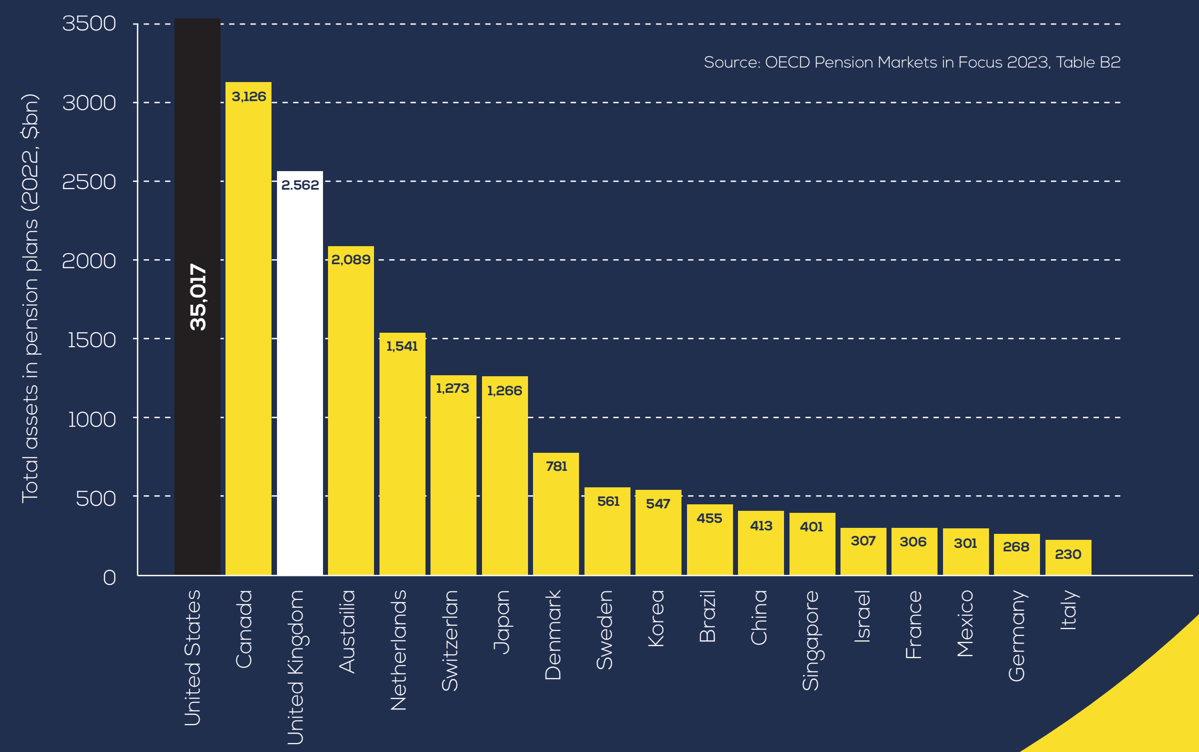
Mansion House reforms focused primarily on the defined contribution (DC) universe, which for the time being is the future of private pension provision in the UK, and is growing at a rate that cannot be underestimated. In 2023, trust-based DC schemes held £143 billion in accumulation pots, an increase of 26% on last year despite a difficult year in the markets.[50] It is predicted that by 2030, the sector will have grown to £420 billion, or around £800 billion if contract-based schemes are included.[51]

However, when it comes to the issue of under-investment here and now, DB schemes and their £1.9 trillion in assets warrant attention. It is true that the majority of such schemes are now closed and will be de-risking as their membership ages or are already in run-off, meaning limited ability to take on risk. However, rising interest rates and improving funding ratios mean that more of those schemes than ever will be able to transfer to the insurance sector, coming under the purview of Solvency UK and the new investment possibilities afforded. On the other side of the spectrum, the large, open schemes like Universities' Superannuation Scheme are leading the pack in terms of allocations to productive assets, with USS allocating around 30% to alternatives.

But there is scope to go further on smaller, poorly performing schemes with no realistic prospect of insurance buyout or any other endgame solution. Idea of transferring these schemes to the Pension Protection Fund (PPF) - an industry-sponsored lifeboat for schemes which effectively go bust - has been mooted in the past, based on PPF's excellent investment and governance record. Since investment management as an activity (to an extent) scales at little marginal cost, opening up this pocket of value in the quasi-public sector more widely makes conceptual sense.

This is particularly pertinent to the UK, which should be a global leader in producing globally competitive asset pools. It is the 3rd biggest pension market in the world by assets, and until very recently 2nd, with Canada overtaking it from 2022 onwards.[52]

Figure 4: Total assets in pension plans, in USD million, 2001-2022



Despite this, it does not have a top 20 or even a top 40 global fund (see Annex A). It is therefore missing out on the benefits of scale. These benefits are substantial: according to the latest annual Global Top 300 Funds study by the Thinking Ahead Institute, top 20 experienced annualised growth rates of 8.8% in the study period, compared to 8.5%, 8.2% and 8.1% experienced by funds ranked 21-50, 51-150 and 151-300.[53]

How much would such soft consolidation of smaller schemes unlock? According to latest data from the Pension Protection Fund (the 'Purple Book') in 2023, there were 1,882 schemes with memberships of less than 100 each, totalling around 80,000 members and £14.8 billion in assets. Looking at schemes of less than 1000 members each, there were 2,194, with a total membership of around 760,000 members and £97.8 billion in assets. And going even further, there were 668 schemes with between 1000 and 4,999 members each, totalling 1.5 million members and £230.9 billion in assets.[54] Of course, since not all small schemes would fit the category of no realistic prospect of buyout, and conversely not every single larger scheme is in a strong position, it is difficult to extrapolate an exact figure which might be unlocked for productive investment.

There is also a question of whether this would create adverse incentives for trustees to purposefully underfund their schemes. Then there is the issue of how the costs of transferring in these schemes in a way that would guarantee full benefits be shared, given these schemes would be underfunded, and PPF is funded by industry levies.

Recommendation 9: A public DB consolidator - whether the PPF, a subsidiary of the PPF or a new public DB consolidator, for example modelled on existing DB Master Trusts - would be set up to offer investment management and governance only: liabilities would stay with the employer, as would the need to pay benefits in full and continue to pay PPF levies.

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