Submission from Scottish National Investment Bank
Legislative Consent on the UK Subsidy Control Bill
December 2021

Background

1. The Scottish National Investment Bank ('the Bank') was established pursuant to the Scottish National Investment Bank Act 2020, and formally launched on 23 November 2020. It is a mission-led development bank providing patient capital to businesses, projects, and communities to build a stronger, fairer, more sustainable Scotland.

2. The Bank received State Aid approval in November 2020, after a long period of constructive dialogue with the European Commission ('Commission'). The Commission's Decision[1] ('the Decision') set out the parameters within which the Bank would be permitted to operate, and enabled the Bank to be capitalised and provide finance upon its launch at the end of the same month.

3. As anticipated, a new subsidy control regime became applicable to the Bank following the UK's exit from the European Union on the 31 December 2020. The Decision no longer strictly applies[2] and it is therefore important that greater clarity is provided by the UK Government around the new subsidy control regime ('Subsidy Control Regime'), its application within a development bank context, and to the Bank in particular. This will enable the Bank to make an informed assessment of its operational constraints and obligations under the new UK Subsidy Control Regime and the Trade and Cooperation Agreement ('TCA').

Background - The Decision

4. The Bank made clear in its notification and in dialogue with the Commission that it intended to operate and make investments on a commercial basis in all but exceptional cases, in line with well-established MEOP practices under EU State aid law, though the Decision retained the flexibility to make investments on an aided/subsidised basis. Notwithstanding this, consistent with established EU development bank precedent, limitations to the Bank's investment activity and process requirements were placed on the Bank, with a view to ensuring a balance between the risk of potential displacement of financial service market activity through the activities of the Bank and achieving the objectives of the establishment and capitalisation of the Bank.

5. The two key parameters placed on the Bank in the Decision were:

   A. all investment had to fit within a pre-determined area of market failure within the EU Market Failure Framework[3] - and within that:

[1] European Commission Decision SA.54780, first published in the Official Journal of the European Union, C 439, 18 December 2020.
[2]The Decision made by the European Commission falls under the previous EU regime of State Aid rules. These
have been replaced, as of 31 December 2020, by a new UK Subsidy Control Regime combining arrangements set out in the EU-UK Trade and Cooperation Agreement, the European Union (Withdrawal) Act 2018, the Internal Markets Act 2020 and World Trade Organisation rules. The Decision is revoked by The State Aid (Revocation and Amendments)(EU Exit) Regulations 2020 (sections 6(c)(i) and 3(i)).
[3] The Decision at para 20 prescribes that the Bank's activities as a market economy operator will only take place where market failures have been established as identified in the Commission's State Aid Guidelines, Communications and Frameworks.

- the Bank could make investments involving aid/subsidy within the limits of established EU exemptions applying under the Market Failure Framework; or
- the Bank could make investments on a commercial basis without aid/subsidy within areas covered by the Market Failure Framework but with restrictions lifted such as maximum aid amounts and aid/subsidy intensities.

B. in every case the Bank required to apply a series of anti-crowding out controls to ensure that the Bank's investment does not 'crowd-out' the private sector through displacement.

The lack of clarity for the Bank / development banks under the new UK Subsidy Control Regime

6. We have noted in the section above the key operational constraints placed on the Bank by the Decision. European precedent around the establishment of development banks dictates that even where the bank in question commits to operating solely on a commercial basis, to the extent that the capitalisation of that bank has been made on what are considered to be sub- commercial terms (involving what is in EU terms described as "level 1" aid/subsidy), subsequent investment activity by the bank (assessed under what is termed "level 2" aid/subsidy considerations) must only be made in areas of identified 'market failure'.

7. This meant that under the Decision, the Bank only had scope to invest in companies or projects:

A. which fell within the definition of one of the pre-existing exemption areas within the Market Failure Framework;
B. on the basis of an individual notification to the Commission where a strong case can be made in line with State Aid principles; or
C. where an ex-ante assessment in relation to a specific sector in Scotland is submitted and accepted by the Commission.

8. As noted above, the Decision no longer applies as a matter of law but there is general reference at article 3.6 of Title XI TCA to ensuring that economic actors use subsidies only for the specific purpose for which they are granted and the non-divergence principles in article 9.4 of Title XI TCA are also recognised.

9. The TCA makes no mention of provisions relevant to national development banks nor does it go into any detail equivalent to seeking to replicate or seeking to replace the previous EU law based regime's approach to national development banks.

10. It follows from the above that there is currently no clarity on the restrictions applicable to the Bank, both in terms of the areas in which it may invest and on the conditions that it must apply.

11. It will therefore be critical for the new regime to be cognisant of the unique case of a development bank and to consider its application within that specific context. This is assumed also to be pertinent for the British Business Bank and the new UK Infrastructure Bank.

12. The core questions that require to be addressed for the Bank / existing development banks are as follows:

A. For a development bank previously capitalised under the terms of an EU Decision which no longer applies, what restraints if any are applicable to that development bank going forward and what process will attach to confirming those restraints? In particular, what constraints would apply to demonstrably commercial investments that an existing development bank makes and that do not involve subsidy, including:

i. **Anti-crowding out** – what measures will a development bank require to observe under the new UK Subsidy Control regime? This will involve the UK confirming its approach to the "objectives" v "displacement" balance noted above.

ii. **Market failure** – the consultation is seeking responses to inform what the new UK Subsidy Control regime will look like relative to its EU predecessor. The key question specific to the development bank context is whether a development bank in the UK will be constrained, when making commercial investments, to areas of 'market failure'? It goes without saying that if development banks are to be constrained to operating in areas of market failure, the new UK Subsidy Control Regime must be at least as wide as its predecessor, and/or sufficient discretion to public bodies and devolved administrations afforded;

iii. **Interaction with the TCA** – to what extent do the terms of the TCA apply to a development bank when investing commercially – in particular what transparency and remedy requirements, if any, will apply in the context of the commercial activity of a development bank?

13. The following sections offer further comment on each of A (i)-(iii) above.

A (i) - Anti-crowding out

14. The Decision stipulated that the Bank must ensure it does not crowd-out private sector investors, and actively seek to 'crowd-in'.

15. The core requirement placed on the Bank is that it seeks 'sufficient objective evidence' that the company or project have been unable to obtain the finance it requires in the market – and that the minimum standard should be either an open call for investment or at least two letters of rejection.

16. Whilst the strict terms of the Decision no longer apply to the Bank, it is clear that under the new regime the Bank must continue to maintain a vigilant approach to 'anti-crowding out' to ensure that it does not displace private sector finance and as such distort the financial services market, principally within the UK.

17. On an interim basis the Bank will continue to apply the anti-crowding out controls contained within the Decision wherever possible. However, greater clarity is sought on the new regime's approach to compliance from an 'anti-crowding out' perspective.

18. It is critical to the Bank that it works in partnership, and not in competition with, the private sector in the pursuit of its missions. Seeking wherever possible to crowd-in private sector finance as well as ensuring it does not displace it, with a view to catalysing activity within key sectors and demonstrating the commerciality of emerging technologies and business models.

A (ii) - Market Failure and The Bank's Missions

19. The Bank's missions have been designed in line with the recommendations made within 'A Mission-Oriented Framework for the Scottish National Investment Bank' developed by the University College London Institute for Innovation and Public Purpose (IIPP).

20. The missions seek to address the long term challenges facing Scotland. The Scottish Parliament and a wide array of stakeholders have been consulted extensively on both the grand challenges and the missions. Strong support was received for both the missions and their ability to address the key economic and social persistent grand challenges facing Scotland.[4]

21. The Bank's dialogue with the Commission throughout the pre-notification process centred around the need to ensure that the existing Market Failure Framework provided enough scope for the Bank to invest broadly and strategically in pursuit of its Missions, and the Bank were ultimately satisfied that the broad scope of the existing Market Failure Framework, alongside the additional options of submitting future ex-ante assessments and/or individual notification, provided sufficient comfort that the Bank's scope would not be unreasonably constrained.

22. It will therefore be important that the design of the new regime affords the Bank sufficient clarity on its operational scope and the necessary flexibility to deliver its missions. In the event that the 'market failure' requirement is replicated under the new regime for development banks operating commercially, an insufficiently comprehensive Market Failure Framework for the UK will not provide the same level of assurance and would require greater analysis on a case by case basis, resulting in increased risk for the Bank.

23. It will also be important that any attempt to design a system of exemption regulations which will apply to the new regime strikes a balance between providing sufficient certainty whilst affording a level of flexibility and discretion for public bodies.

24. The Bank is of the view that the application of its own robust assessment of mission alignment and impact assessment on a case by case basis will enable it to demonstrate compliance with the TCA principles where necessary, in particular as the basis for demonstrating that an objectively justifiable 'public policy objective' is being pursued in each case.

A (iii) – Interaction with the Trade and Cooperation Agreement (TCA)

25. The Bank recognises that its activity could engage the TCA directly (in terms of triggering a dispute between the UK and the EU) where it invests in a sector that is engaged in European trade and/or markets (or where the Bank's activities impact on financial services markets to an extent capable of distortion between the UK and EU).

26. The Bank’s activity would potentially engage the TCA if it involves providing ‘subsidy’ that confers an advantage capable of having an effect on trade or investment as between the UK and EU. This is viewed as more likely if the Bank invests on an aided/subsidised basis, and as noted above, the Bank’s clear focus is on commercial investments.

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[4] Scotland's Economy Parliamentarystatement on the ScottishNational Investment Bank - Scotland's Economy (blogs.gov.scot)

27. The Bank considers that where it is acting commercially, it ought not to create harmful or distortive effects either as between UK and EU markets in terms of the TCA or within the UK (in terms of the potential extension of principles to intra-UK markets). On this basis, the Bank seeks clarity on the extent to which the transparency requirements and remedies envisaged within the TCA apply to commercial investments made by a development bank.

Dialogue between the Bank and UK Government

28. On the basis of the contents of this response, the Bank seeks to open a dialogue with the UK Government with a view to giving more in-depth consideration to the matters detailed within.

Scottish National Investment Bank