

Strategic Investment Bank Financing Ireland's Investment Economy

1. Introduction: a daunting challenge

The Irish Economy is experiencing one of the worst recessions of any developed country since the Second World War. Ireland was one of the first economies to go into recession and may be the last developed economy to see a return to growth. The collapse of our construction and credit-induced bubble coincided with the global financial crisis to produce this collapse in output. However our recession has been particularly severe and Ireland is among the worst performing Eurozone economies, particularly in terms of jobs.

Unemployment, which stood at less than 5% in 2008 is expected to reach approximately 14% in 2010. The numbers on the live register have increased by 250,000 in two years and will continue to climb into 2010.

While the Irish economy will eventually recover from this crisis, as the world economy picks up, and consumer confidence creeps back, there is likely to be a long-run impact from the crisis. The extent to which unemployment falls, and the economy grows, will depend on Government having a coherent strategy for jobs and investment - a strategy for replacing the lost jobs in construction with new employment in other sectors, for returning Ireland to export-led growth and for supporting innovation.

The transition that must be made is from an economy fuelled by credit and consumption, to one driven by exports and investment. Labour's strategy is to develop policies that will facilitate and accelerate that transition. It is based on our understanding of how innovation will drive economic growth in the coming decade. Rhetorical commitment to the 'smart economy' is not a substitute for the significant shifts in policy that are required if Ireland is to succeed in this necessary transition.

2. An investment economy

The core objective of our economic policy is to replace Fianna Fail's casino economy with a sustainable investment economy.

A sustainable investment economy is one where innovation is promoted across all sectors, where there is an environment that promotes firm start-up and expansion, and where there is a commitment to the provision of world-class infrastructure. These are closely linked: investment in infrastructure like renewable energy, next-generation communications networks, smart grids and electric transport will create the environment for a new wave of indigenous companies focused on the huge opportunities that will arise as a result of the expansion of digital technologies and the transition to a low-carbon economy over the coming decades. Those companies must also have access to working capital and growth capital, and to a range of other supports.

Furthermore, improved infrastructure will enhance Ireland's competitiveness and attractiveness as a location for foreign direct investment. In order to restore our competitiveness and productivity we need a sustained programme of investment in the 'right' capital: transport, energy, communications and innovation and not thousands of empty houses in ghost estates, the most notable legacy of Fianna Fail's bubble.

There are a number of major obstacles, however, to realising this vision. In respect of working capital and growth (or venture) capital for firms, the banking crisis has seriously impaired the capacity of Irish Banks to lend into the SME sector and to firms with high-growth potential. By the beginning of 2010, it is already clear that access to finance is a significant constraint. This situation was recently summed up by the Governor of the Central Bank in the following terms:

'I think it's fair to say – and what data we have seems to bear this out – that banks in Ireland reacted to their own difficulties and to the downturn by greatly reducing their risk appetite. Some of this was a necessary adjustment, but the result has been limited availability of credit for start-up firms and SMEs. Indeed, I have the impression that, during the years of property-based lending, the banks have lost their edge in small business lending'

As banks repair and shrink their balance sheets, it is unlikely that this position will be reversed.

At the same time, Ireland's fiscal position and the restrictions imposed by the Stability and Growth Pact (SGP) represent a major constraint. There is little prospect that the level of investment necessary to improve our infrastructure can take place in the next decade given the current state of the public finances. And even without the fiscal crisis, the SGP, which includes public capital investment as part of its limit for the budget deficit, would restrict the State from making the necessary investments.

In Budget 2010, the Government stated that it had approved a capital spending envelope of some €39 billion for the seven year period 2010 – 2016. A review of spending priorities has also been undertaken and is to be published 'shortly'. The profile for capital spending set out in Budget 2010, shows nominal spending of €6,466m in 2010, or approximately 5% of GNP. This is projected to fall to €5,500m in 2011 and for each year to 2014 (effectively, this figure will remain constant in nominal terms to 2016, given the €39 billion envelope). On the basis of reasonable assumptions, therefore, capital spending will fall from approximately 5% of GNP in 2010, to approximately 3.1% in 2016, averaging approximately 3.8% of GNP for the period as a whole. While this appears to be a substantial commitment on the part of the State, it falls well short of the 5% figure to which the Government was previously committed. As shown in Appendix 2, the profile for exchequer funding also falls short of that recommended by the ESRI in its 2006 study, even after adjusting for reductions in tender prices due to the recession. This funding gap and the reluctance of the Government to propose any constructive strategy for closing it means that the investment necessary to underpin our transition to an export-led, knowledge economy will be severely constrained unless alternative forms of funding are found.

The investment economy cannot be realised using the current funding mechanisms. We need a fresh approach to investing in innovation and to financing and developing infrastructure. A key element of this approach is the establishment of a new Strategic Investment Bank.

3. The Strategic Investment Bank

Labour believes that the best way to address the capital and SME funding gaps is to establish a Strategic Investment Bank (SIB) which would lend to SMEs, invest in innovative companies and raise finance for appropriate infrastructure projects.

The SIB would be broadly modelled on the German Kreditanstalt für Wiederaufbau (KfW), and on the ICC/ACC models that previously operated in Ireland (For a summary of KfW see Appendix 1). The intention would be to develop the SIB both as a business bank, and as a public finance powerhouse that would radically change the manner in which proposed public investment is appraised, planned and financed.

Funding SMEs and innovative, high-growth companies

Despite the enormous funds that will be transferred to the banks via NAMA, the IMF and the Banks themselves admit that it is highly unlikely that NAMA bonds will be channelled into lending to the productive sector of the economy in the medium term. Even with NAMA bonds flowing to the banks, it is far more likely that banks will seek to shrink their balance sheets for a number of years to come. Even before the present crisis, the track record of lending to SMEs was poor. It is highly unlikely, therefore, that the existing banks will meet the requirement for credit from the productive sector of the economy and particularly for both existing SMEs and innovative companies with high growth potential.

This is a major market failure, which must be redressed through public policy, if the downturn in the economy is not to be lengthened and worsened, and if the necessary re-alignment of the economy is to be achieved. The SIB, therefore, will have a mandate to lend directly to the enterprise sector, providing working capital and growth capital, including asset finance (such as, for example, for fixtures and fittings or for capital equipment).

We also believe that the SIB would be an appropriate body to make venture-capital investments on behalf of the state in innovative SMEs with high-growth potential, in particular in relation to exports, the digital economy and low-carbon technologies. We envisage that the SIB would work in conjunction with Enterprise Ireland targeting companies for whom bank finance is either inappropriate or unavailable. Following a detailed appraisal, the SIB will invest in such companies seeking funds of between €2 and €10 million. We will also examine the possibility of scaling up the funding for such companies by attracting matching funding from the private sector to co-invest with the SIB.

The SIB would also be able to draw down on funding from the European Investment Bank for lending to SMEs.

Financing capital investment

There are currently three methods of financing infrastructure in Ireland:

- i. Direct Exchequer funding – for traditionally procured capital projects like schools, hospitals etc.
- ii. Public Private Partnership (PPP) projects – originally for projects where there was a user charge like motorways but increasingly for social infrastructure like schools, hospitals and housing. These projects have been financed by non-recourse lending secured against user payments or payments from government to the private consortium.
- iii. Debt financing of semi-state utilities – for example bonds raised by ESB, BGE etc.

A key reason for the development of the PPP approach to funding public infrastructure was to meet some of the nation's infrastructure needs without breaching the SGP restrictions on the level of the public deficit. The PPP system in Ireland, has, however, encountered a number of problems. Firstly, the cost of PPPs has been the subject of some criticism, particularly since the cost of funding PPP projects is greater than if the state were simply to borrow the money itself.

Secondly, the banking crisis has dramatically reduced the level of interest in PPPs among potential investors. The availability of finance for PPP projects from both domestic and foreign banks has effectively dried up since the credit crisis began. Where finance is still available, it is for shorter periods than the life of the infrastructure project in question and at a much greater cost, mostly rendering the PPP funding model unviable.

There is nothing to suggest that the private banks have any appetite to continue to finance such projects once the guarantee expires. Indeed bidders for Metro North have explicitly stated that the Government will have to underwrite the financing risks in order for the project to be built.¹ Private bidders have made it clear that in order for PPPs to be viable for them, the state will have to contribute more to their cost, thereby undermining the argument that PPPs represent better value for money than traditional public capital investment.

Instead, we need to put in place a fresh approach to public investment that harnesses the ability of the state to borrow for capital investment and of the private sector to deliver projects on time and within cost. An approach that will stimulate the economy, create employment and support our vision for the investment economy.

Labour is proposing that the SIB would lead this new approach to funding infrastructure projects. While it would continue to harness the ability of the private sector to deliver projects on time and within cost, it would leverage the ability of the state to borrow money for capital spending significantly cheaper than private operators. It would thus play to the strengths of both the state and the private sector.

¹ See Frank McDonald, 'State must back metro financing, says bidder', Irish Times, 14 April 2009.

The SIB would do so by identifying a project or bundle of projects and by then taking the lead role in financing them. It would prepare and issue bonds on the international capital markets and to institutional and retail investors. The private consortium appointed to design, build and operate the project or projects in question would borrow the project funding from SIB (and through SIB from other lenders), for a small margin over the coupon SIB would pay on the bond in order to cover SIB's costs.

Projects that would be funded by issuing bonds would include those where there was a user charge like roads, public transport, waste, communications and energy, as well as social infrastructure like health, education and cultural facilities where the state pays an annual fee for use of the facility. The private consortium would repay the SIB over the duration of the project from user charges or else from the payments it would receive from the sponsoring department or agency for the construction, operation and maintenance of the project. SIB lending would reduce the cost of funds to private consortia, resulting in the provision of critical public infrastructure at a lower cost to the public purse and to users of services provided than the current PPP system.

4. Organisation, operation and governance of the SIB

The SIB would be a commercially-focused and independent Semi-State Company. During its start-up phase, it would of course benefit from the same State guarantee that is available on a short to medium term basis to all banks operating in Ireland.

It is envisaged that the SIB will have the benefit of an ongoing State guarantee for its activities in the funding of public infrastructure projects, either by operation of law (where these projects fall outside the scope of EU State Aid rules) or, if necessary with Commission approval .

It is also envisaged that, for so long as there is no effective market operating in Ireland for the provision of risk capital or credit to start-up firms and SMEs, Commission approval will be sought for a State guarantee to the SIB for its operations in this area also.

We recognise, however, that the field of application of the guarantee may have to be progressively reduced over the years, as and when a fully functioning banking system is restored, so as to avoid breaching EU rules on the distortion of competition by the provision of State Aid to a single participant in a functioning market.

Thus, the SIB could become a strong partner with domestic and foreign sources of capital to finance our national infrastructure requirements, while also playing a key role in financing the development of firms in the knowledge economy.

We would initially capitalise the SIB by making a direct capital contribution from the National Pensions Reserve Fund. We currently anticipate that this would be of the order of €2 billion. It would then be in a position to issue its own long-term bonds with conservative leverage and to raise other forms of funding including deposits. SIB would make no distribution of profits and all profits would be retained to increase the capital base of the bank.

SIB bonds would be issued in international capital markets and would also be offered to Irish and international pension funds and retail investors. It would also market the retail bonds to the global Irish diaspora. In order to increase the attractiveness of SIB bonds as an asset class for Irish residents, we would consider exempting income from them from tax. In considering this matter, we will review the experience with the Recovery Bond being introduced in the 2010 Finance Act.

SIB will be a statutory corporation whose functions and objectives would be set out in legislation. The Government would appoint the board of the SIB but it would act independently of government.

The Governance of the Bank, and the procedures used in financing individual infrastructure projects would be designed having regard to EUROSTAT rules that determine which institutions are regarded as being outside of the General Government sector. While the SIB would be wholly owned by the state, it will operate independently of Government and would not therefore solely be an instrument of government policy. It would seek a commercial return on its investments in the areas of SME lending and provision of risk capital and the Government would not have the power to oblige it to enter into transactions that it did not believe to be economically viable. This level of autonomy would result in SIB debt not being viewed as forming part of overall government borrowing.

We envisage a conservative capital ratio for the bank of approximately 10%. This would allow for total lending of some €20 billion. The balance of lending between SMEs and infrastructure projects would be a matter for the Board of the Bank and would be subject to commercial and prudential considerations. While a significant funding gap for the public capital programme is emerging which the bank is intended to address, the amount of lending actually undertaken in this manner will depend on the number and scale of projects included in the national development plan and the public capital programme that are deemed suitable for this form of financing. In many cases, SIB will be in a position to act as a catalyst for additional funding by for example pension funds.

Labour in Government will bring forward a new NDP, and will regularly review the investment priorities of the state. These programmes will be reviewed and analysed by the SIB in order to advise the Government on those that are appropriate for funding by way of SIB bonds. However the final decision on involvement in any project will rest with the SIB Board. The total share of any project financed by the bank will also be subject to commercial and prudential considerations. It may also be affected by Eurostat rules.

5. Summary of our proposals

- Establish a new Strategic Investment Bank with a primary objective of investing and lending for national economic development, including investment in infrastructure and the enterprise sector.
- SIB will have full operational independence from Government.
- SIB would be capitalised by equity investment from the NPRF.
- Government would guarantee the SIB –
 - initially, on the same terms as are being offered to all other banks,
 - providing credit to SMEs, by agreement with the EU Commission, for so long as there is no effective market participation by the commercial banks, and
 - on a long term basis, for the funding of public infrastructure projects.
- SIB would originate funding for public projects it deems to be appropriate
- Private companies would continue to have a role in constructing, operating and maintaining projects.
- SIB would be responsible for lending to the enterprise sector to address the market failure left by the existing banks.
- SIB would make no distribution of profits and all profits would be retained to increase the capital base of the bank

Appendix 1

Kreditanstalt für Wiederaufbau (KfW)

KfW was established in 1948 as part of the Marshall Plan, with the primary objective of supporting the reconstruction of the German economy. Over 60 years later it is now Europe's largest 'promotional' bank, owned 80% by the Federal Government and 20% by the German Länder. It has a nominal capital of 3.75 billion euro and balance sheet total as of 31 December 2008 of EUR 395 billion, making it one of the ten largest banks in Germany.

KfW's role in the German and wider economy has broadened significantly since establishment and the group now spans the following activities:

Financing housing:

KfW supported the massive post-war reconstruction of 90% of the German housing stock and more recently financed the modernisation of nearly half of all apartments in the former German Democratic Republic following reunification in 1990.

SME funding:

KfW provides loans and ongoing financing to the 'Mittelstand' small and medium enterprise sector in Germany. During the current recession, it has played an important role in supporting the Mittelstand with innovative financing instruments in order to optimise the overall financing conditions for that sector.

Project and export finance:

KfW's subsidiary, KfW IPEX-Bank GmbH offers modern financing expertise and experience in all areas of international project and export finance. In addition to SME finance, export finance is another main pillar of KfW's promotional business. KfW has traditionally offered German exporters more reliable financing at lower interest rates for export transactions and other cross-border investments.

Development finance:

KfW supports developing countries on behalf of the German Government. Initially the focus was on major infrastructure projects in the fields of energy supply, transport and irrigation. Local development banks were also supplied with credit lines to enable them to support the investment projects of their customers. More recently KfW has focused on helping people in developing countries to sustainably improve their living conditions both socially and economically, such as by building schools or health facilities. KfW is also a major provider of microfinance in developing countries.

Environmental finance:

Supporting environmental and climate protection has become a major priority for KfW. Currently KfW is investing 20 per cent of its entire financing volume in national and international environmental projects. In developing countries, KfW has become one of the largest investors in renewable energies.

Appendix 2: Estimating the Capital Spending Gap

The last comprehensive analysis of the appropriate level of capital spending in Ireland was undertaken by the ESRI in 2006. While Ireland's changed economic circumstances mean that a new study of capital requirements is needed, the ESRI study remains the best available benchmark. This study recommended an average annual exchequer capital spend of €8,403m in 2006 prices, over the seven year period 2007-2013. The study argued that a greater level of spending would have been appropriate and would have achieved positive economic returns, but was not recommended because of the likely inflationary impact that additional spending would have had on the construction sector and on the broader economy. This alternative higher spending package was modelled in terms of €9,992m in 2006 prices. In terms of GNP, the recommended package amounted to 5.5% of 2006 GNP, while the larger package amounted to approximately 6.5%.

Since 2006, tender prices in construction have fallen rapidly. The table above shows the 2006 recommended level, adjusted for the change in construction tender prices over the period 2007-2009. By 2009, the ESRI recommended level of investment amounted to 4.8% of GNP. (A similar exercise carried out on the higher suggested spending level produces a figure of 5.7% of GNP for 2009.) The table then extrapolates this recommended spending level out to 2016 by calculating it as a fixed share of GNP i.e. 4.8%.

Comparing this recommended spending to actual expenditure, we see that capital spending did not fall in line with prices over the period 2008-2010. Assuming that Government took advantage of lower tender prices (a very strong assumption), this means that spending was ahead of the ESRI recommended level in 2008, 2009 and 2010.

The picture with respect to planned expenditure, however, is very different. Budget 2010 states that the Government has agreed a capital spending package of approximately €39billion for the seven year period 2010-2016. (A review of capital expenditure priorities has been undertaken, but has not been published). The table shows how this €39billion will be allocated on a year-by-year basis. It shows exchequer capital spending falling as a share of GNP to 3.1% in 2016. This is based on Department of Finance forecasts for GNP out to 2014, and assumes 5% nominal GNP growth in 2015 and 2016. When contrasted with the ESRI recommended level of spending (4.8% of GNP), there is a shortfall of €11.8 billion over the period 2010-2016.

Year	GNP	Exchequer capital spending	Capital Spending/GNP	ESRI Recommended Spend	Gap
2006	152529	6423	4.2	8403	
2007	161244	7695	4.8	8369	674
2008	154596	8915	5.8	7623	-1292
2009	133175	7354	5.5	6381	-973
2010	129100	6466	5.0	6197	-269
2011	135375	5500	4.1	6498	998
2012	143750	5500	3.8	6900	1400
2013	152275	5500	3.6	7309	1809
2014	160700	5500	3.4	7714	2214
2015	168735	5500	3.3	8099	2599
2016	177172	5500	3.1	8504	3004
Total 2007-2013		46930	4.7	49277	2347
Total 2010-2016		39466	3.8	51221	11755