

FIN(4)FW070
Finance Wales Inquiry
Response from the Board of Finance Wales plc



National Assembly for Wales

Finance Committee Inquiry – Finance Wales

Response of the Board of Finance Wales plc

January, 2014



Introduction

This is the response of Finance Wales' board to the invitation to provide evidence in relation to the Finance Committee's short inquiry to consider the current and future role of Finance Wales.

This response includes 4 appendices.

Q1 The role and strategic purpose of Finance Wales

a) Should it be self-financing by operating on commercial investor principles, or should it primarily support the economic development priorities of the Welsh Government?

- Firstly it is important to recognise the somewhat unique structure of the Finance Wales Group which encompasses both Fund Holding company activities and Fund Management company activities, making the investments from these funds on a commercial basis. The principle of being self-financing applies differently to these two quite distinct segments, namely fundholding operations and commercial fund management operations.
- For the avoidance of doubt Finance Wales does not benefit itself from any income from the funds it manages apart from the agreed management fees. All interest and fees paid by SMEs in respect of loans and investments are retained within the funds themselves and form part of the potential legacy for future funds to invest in the next generation of SMEs.
- At the Funds level Finance Wales raises funds from both public and private sources with the overall aim of returning all capital to stakeholders plus a suitable return as required. Thus sources of capital such as the European Investment Bank (EIB) and Barclays look for the return of capital and a commercial financial return thereon as a first call on the fund. The public money via European Structural Funds such as European Regional Development Funds (ERDF) and Welsh Government capital monies require the creation of legacy funds for future investment in the next generation of SMEs and economic development through a series of outputs such as jobs created and safeguarded, but without a requirement for a commercial return on the capital. In our latest forecasts for the Wales JEREMIE Fund¹ as an example, Finance Wales is forecasting a shortfall of 17% in the return of public capital. This amounts to a shortfall of some £14m out of the total likely public sector capital of £82m, which could be construed as representing the economic development element within the funds.
- We would stress, however, that we do not regard commercial returns and economic development as in any way mutually exclusive. We seek to achieve

¹ The Wales JEREMIE Fund (Joint European Resources for Micro to Medium Enterprises) is a £150m fund that helps Finance Wales to provide finance to SMEs. Finance Wales secured £75m from the European Investment Bank (EIB) and European Regional Development Fund (ERDF) backing to create the first JEREMIE fund in the UK.

both of these objectives, reflecting the diverse requirements of the different stakeholders in the funds.

- The Finance Wales Group aims to fully cover its operating costs and be self-financing from a mixture of fund management fees, currently ca. £6.5m and fundholding fees ca. £4.0m.
- Fund management fees are generally agreed via an open fund management procurement exercise or at market rates. Typically these are between 2%-3% p.a. and are set for the investing period of the funds, which are typically 5 years.
- Fund Holding fees are agreed in line with EC guidelines which permit fees of between 1%-2% p.a. Currently the Holding Fund fees charged by Finance Wales plc are set at 1.5% as the mid-point in this range and these are set out in the Finance Wales Group's Business Plan 2013/14 which was submitted to the Welsh Government for approval in May 2013. These are covered by £1.6m taken directly from the Funds and ca. £2.9m via the Welsh Government in the form of an annual grant-in-aid payment. At £2.9m in 2013/14 this represents the only revenue support currently provided to Finance Wales and compares to a figure of £5.6m in 2008/09. It remains the strategy of the Finance Wales Board to continue to reduce this year on year, as new fund management contracts are acquired, with a view to becoming self-financing without calling further on the public purse.

b) How do banks operate alongside public bodies such as Finance Wales and, how could this be improved?

- Banks work very closely with Finance Wales – our current major introducers of business are Barclays and Lloyds. These account for 36% of our referrals.
- In total Finance Wales has provided funding of £115m from its main Wales JEREMIE Fund up to 30th September 2013 and this has helped raise an additional £133m funding from private sector sources, primarily banks and other financial institutions such as other private equity and venture capital companies, making total funds of £248m available for Welsh SMEs.
- We have very strong relationships, through our offices across Wales, with all the local Regional Directors and Managers and there are high levels of cross-referrals made. These relationships have been forged over many years and are key to providing support for SME customers of all banks in Wales.
- Both the EIB (see later) and Barclays have been stalwart supporters and lenders to Finance Wales over many years with total facilities agreed of £155m over this period.
- Barclays, RBS and Santander are also keen to lend directly to Finance Wales, alongside the British Business Bank, to enable it to invest in Welsh SMEs in connection with the proposed Finance Wales/Welsh Government Wales Mid-Market Fund of £80m.

- We continually seek to broaden and improve these relationships as new providers appear such as Handelsbanken. This remains a key focus for Finance Wales going forwards.

Q2 Current performance

a) Has Finance Wales achieved appropriate outcomes in areas such as jobs created/safeguarded, business support, return on investment, economic impact, associated private sector investment etc.?

- In summary the following key total outputs have been achieved by Finance Wales since its inception in 2001:
 - Jobs created 13,068
 - Jobs safeguarded 19,986
 - Private Sector Leverage £447m
 - Amount invested £275m
 - Number of enterprises supported 3,066
- Please see Appendix 1 for a more detailed breakdown of the outputs and performance against actual targets in our current active Funds.
- These outputs are agreed between Finance Wales and WEFO/the Welsh Government at the set-up of each fund and are monitored quarterly by way of formal reports.
- In addition, these outputs are subject to formal mid-term and final evaluations by independent consultants, commissioned jointly by Finance Wales, the Welsh Government and WEFO. An executive summary of the latest evaluation report on the Wales JEREMIE Fund completed by Regeneris in February 2012 is attached at Appendix 2. For some of the economic development outputs, the deteriorating economic circumstances of recent years has had a major effect, e.g. high unemployment rates and low levels of job creation; paucity of bank lending, etc.

Q3 Interest rates charged

a) Are these appropriate relative to those charged in the private sector or other sources, and given State Aid requirements?

- We believe that our interest rates are indeed appropriate and in line with those charged by the private sector whilst being fully compliant with State Aid requirements
- We provide at Appendix 3 a copy of the formal response that Finance Wales has provided to the Welsh Government in respect of the Access to Finance Review which addresses these aspects.

b) Should interest rates charged by Finance Wales be commensurate with risk?

- The Management Arrangement, which governs the relationship between Finance Wales and the Welsh Ministers, acting by the Welsh Government, is our current governing document and sets out the remit and purpose of Finance Wales.
- The first paragraph of the General Purposes and Aims (section 3.1) states that:

‘The Company shall be managed as a group of commercial development funds to provide businesses in Wales with flexible and sustainable finance for their development. Its activities seek to address market failure in this area and stimulate new investment by the private sector’

- This document has been regularly reviewed by Finance Wales and the Welsh Government, most recently in June 2013 and no changes have ever been made to this primary objective. Moreover each year Finance Wales submits a formal Business Plan to the Welsh Government setting out clearly the core strategic aims of Finance Wales for the coming year.
- The Chairman of the Finance Wales Board also meets with the Minister regularly to ensure alignment with Welsh Government policy and to consider new initiatives.
- This focus on commercial development funds requires that we adopt a commercial interest rate policy commensurate with the risk profile of each SME to whom we lend.
- Please see Appendix 3 regarding the actual rates charged by Finance Wales, the level of risk premiums charged and the related State Aid considerations around EC Reference rate methodology for further details.
- Because the majority of Finance Wales’ funds have to attract at least 50% private sector capital it is critical that the appropriate commercial risk judgements are made and these are reflected in the underlying financial models that are carefully reviewed by the private sector banks involved, being primarily Barclays and the EIB.
- Both banks have been very clear in our discussions at the time that the funds were originally set up and in their recent responses to the Access To Finance Review, that any deviation from this commercial risk-based approach would be detrimental to their view of the funds and could possibly limit their future support if Finance Wales were to move away from this approach.
- A similar view has also been expressed to senior officials of Finance Wales by the British Business Bank in connection with the proposed £80m Wales Mid-Market Fund noted above.
- These are the inherent challenges of managing public/private mixed funds as required by EC State Aid guidelines. In devising its investment strategy and risk

appetite, Finance Wales seeks to balance these two requirements, as noted above in our response to Question 1(a).

Q4 Value for Money

a) Does Finance Wales provide value for money to the Welsh Government, and how does it compare relative to other forms of public intervention and support?

- We believe that Finance Wales does provide very good value for money to the Welsh Government, as demonstrated by the outputs achieved as detailed above in response to Q2.
- As noted above Finance Wales has sought to reduce the current Welsh Government grant-in-aid contribution year on year from a figure of £5.6m in 2008/09 to the current ca. £2.9m.
- Our Board's objective is to increase further the level of self-financing in the coming 2-3 years as JEREMIE 2 and other new funds come on stream.
- Our recent support for the Housing and Regeneration Department's Help to Buy - Wales initiative is a further example of providing value for money, where we are providing a back office service at cost to that Department rather than them seeking a more expensive private sector alternative. Here the relative scale of Finance Wales allows it to absorb the management of additional funds cost effectively.
- We have also offered and provided due diligence advice to the Department for Economy, Science and Transport and the Department for Housing and Regeneration on a range of projects at nil cost.
- As noted above both our Holding Fund and Fund Management costs are benchmarked against the market, either via public procurement exercises or against standard EC guidelines.
- All of these activities are managed with a current staff headcount of 121.
- Within the recent Regeneris mid-term evaluation Report (December 2013) on all three of the English JEREMIE Funds, it noted that all JEREMIE funds in the UK offer considerable value for money compared to the alternative of providing grants. This is due to their ability to attract matched funding and return legacy funds for the benefit of future generations of SMEs.
- The public sector capital grant per gross job created in the Wales JEREMIE Fund is around £31k as at 30/09/13. Including the currently projected legacy of c.83% of public funds returned, this drops to c. £5k per new job created.
- Additionally and bearing in mind the current extremely difficult employment conditions prevailing, if we include the total numbers of jobs safeguarded as a result of the investments made by Finance Wales the equivalent combined figures are 8,300 jobs created/safeguarded in the Wales JEREMIE Fund to 31/12/13.

Q5 Arrangements for future sources of finance

a) What potential forms of finance should be considered by Welsh Government for Finance Wales (including sources such as European Funds and the European Investment Bank)?

- Finance Wales in collaboration with the Welsh Government actively seeks new potential sources of funds from a range of private and public sector sources as set out below.
- These are in addition to the existing sources such as the European Structural Funds (ERDF), the European Investment Bank, Barclays Bank and the Welsh Government, where we have successfully accessed funds totalling £363m in recent years of which £155m has come from the private sector.
- As noted elsewhere we are currently in dialogue with the British Business Bank, Barclays, Santander and RBS to establish a £80m Wales Mid-Market Fund for SMEs, to be launched hopefully later this year.
- This fund will also involve us seeking to raise £10m from Welsh-based Pension Funds and initial meetings are planned for January 2014.
- We continue to actively consider all possible sources of potential capital, such as the European Investment Fund with whom we have established relationships arising from the Wales JEREMIE Fund.
- In addition to proactively seeking new sources of funds, we are also active in seeking to raise new innovative funds to support Welsh based SMEs.
- In response to a request from the Minister for Economy, Science and Transport in May 2012, to look at other potential forms of support for SMEs, Finance Wales undertook a series of staff workshops over the summer of 2012 and submitted a number of proposals for consideration in November 2012. These were in addition to the Wales SME Investment Fund of £40m which launched in 2012 and the Wales Micro-business Loan Fund of £6m which launched 2013.
- Four additional funds were proposed which included the Wales Property Development Fund of £10m launched in May 2013, plus three further funds; a £20m Working Capital Fund, a £7.5m Proof of Concept Technology Fund and a £25m Management Succession Fund. These are now under consideration and will hopefully be launched shortly.
- It is proposed that the Management Succession Fund will also involve support from Welsh Local Authority Pension funds as the private sector match alongside the Welsh Government for State Aid purposes.
- As noted above, Finance Wales has also worked on a bid to the British Business Bank (BBB) during 2013, for a new Wales Mid-Market Fund. This was submitted to the BBB in September 2013 and was agreed in principle in December, with a formal submission due to be submitted by the end of February 2014.

- During the second half of 2013, Finance Wales has also formulated plans with WEFO, the Welsh Government and the EIB for a follow-up to the current Wales JEREMIE Fund. Positive discussions were held with both WEFO and the EIB in December 2013 and we are meeting with the EIB again in March 2014 at their request to discuss our proposals more fully. In the meantime we have commissioned Regeneris (see also above) to undertake a detailed Capacity Analysis on the current extent of market failure in access to finance for SMEs across Wales. This will involve a series of consultation workshops across Wales in February and we expect their Report to be available in late February. This will form the basis for a detailed State Aid Notification to be submitted to the European Commission and a framework to discuss with WEFO, the Welsh Government and the EIB, the likely scale and mix of products to be included.
 - The development of a second Wales JEREMIE Fund is a major plank of Finance Wales' strategic planning for the period 2013-2015. Based on our previous experience in developing the first ever EIB-backed JEREMIE Fund in Europe in 2007-09, we are aware that the development of a JEREMIE Fund takes a minimum of two years, hence the early planning already being undertaken to ensure that Welsh SMEs are able to seamlessly access funding once the current JEREMIE Fund is closed in September 2015.
- b) The stage 2 report proposes that it should be less confusing for Welsh SMEs if all sources of finance, including UK programmes, were combined. Would it be beneficial to devolve a proportion of UK public support programmes to be administered in Wales?**
- Whilst it is proper to review these arrangements and challenge conventional wisdom, there are a number of factors to be taken into account. These need to be fully debated and assessed carefully before considering such a significant change in the current structures.
 - The Access To Finance Review does recommend that all funding and business support activities should be merged into a Wales Development Bank. This may make access to finance less confusing but historically in Wales, Scotland, Northern Ireland and England these two functions have been kept separate.
 - This is to ensure that the best advice to SMEs is properly and independently sourced and at arms' length from the sources of funding themselves. This avoids potential conflicts of interest and allows expectations of a favourable response to be managed properly.
 - This may not be possible in a much larger all-embracing organisation that combines business support and delivery of funding in one place.
 - It should also be recognised that the current business support mechanism, Business Wales, was itself only restructured and launched in January 2013 under a three year contract and debatably it is too early to assess its full impact at this time.

- On the issue of a wider proportion of UK public support programmes being administered in Wales, we would merely note that many UK schemes have already been introduced in Wales, e.g. the Help to Buy - Wales scheme, the UK Start-Up Loan scheme. Enterprise Finance Guarantee Accreditation was acquired in 2013 by Finance Wales.
- Some schemes such as the EIS/SEIS are controlled by HM Treasury as both involve taxation issues. Others such as the Enterprise Capital Funds (ECFs) are available in Wales already although very few ECF managers visit Wales and Finance Wales is already able to fill this equity gap from its existing funds.
- The Access To Finance Review suggests that the Business Growth Fund should also be moved but this is not a public support mechanism, as it is being backed solely by the High Street Banks with no public money involved.
- There are also risks in combining both advice and commercial funding into one Welsh Government body in terms of losing the valuable “venture capital investor exemption” which is currently available to Finance Wales as an arms-length commercial enterprise. Any changes in this arrangement need to be carefully assessed as it could impact on the definition of what constitutes an SME. This could make some SMEs ineligible for Finance Wales funds under current European Commission guidelines and potentially ineligible for R & D tax relief.

Q6 Corporate Structure of Finance Wales

a) Is the current structure fit for purpose and what potential alternative models could be considered?

- Please see attached as Appendix 4 a summary of the current Finance Wales Corporate Structure and Governance. This may help inform the Committee of the complex governance and regulatory controls that Finance Wales, as a financial institution is subject to.
- In addition there are a range of State Aid considerations to be considered and which have been covered in more detail as part of our formal response to the Access To Finance Review (Appendix 3).
- This corporate structure has evolved over many years as circumstances require in conjunction with the Welsh Ministers.
- The current arms-length commercial investment decision-making model has a number of benefits for Welsh SMEs.
- The structure allows Finance Wales to offer flexible funding options, whether they are equity or debt based, tailored specifically to each Welsh SME’s individual need based on its experience of funding SMEs over many years.
- This independent commercial approach allows us to bring other commercial investors to the table who would be less inclined to offer co-investment support if Finance Wales was perceived to be operating on a non-commercial basis.

- It also allows us to build long term successful relationships with SMEs and enables us to offer follow-on funding speedily based on known track records.
- Moreover under the current structure, Finance Wales holds key FCA and CCA regulatory authorisations and licences and any proposed change in structure would need to be carefully considered as the current licences may no longer be valid. See also comments above in response to Question 5, regarding the “venture capital investor exemption” considerations.
- Finally, consideration needs to be given to the European State Aid Risk Capital Guidelines which cover all Finance Wales current funds in looking at potential alternative models. These require that all “investments are profit driven”. Similarly all Fund Managers need to operate a “commercially sound investment strategy” and be suitably incentivised to do so.
- As such it is the firm view of the Board of Finance Wales that the current structure is fit for purpose and should remain in place. It offers great flexibility to respond to the needs of the Welsh Government, whether on new schemes such as Help to Buy - Wales, or in the creation and establishment of new funds, such as those noted in Q5.

Q7 Activities of the Finance Wales Group in the North of England

a) Is this of benefit to the economy and SME businesses of Wales?

- We firmly believe that these activities are beneficial to the Welsh economy and SME businesses in Wales.
- It would perhaps be helpful to set out the background and original circumstances in 2008-09 when the decision to undertake activities outside Wales was discussed and finally agreed with the then Minister for Business, the Economy and Transport in early 2010.
- As part of the due diligence commissioned by the EIB in 2008, the European Investment Fund (EIF) undertook a detailed review of Finance Wales on behalf of the EIB. During that review discussions arose regarding the possibility of Finance Wales becoming involved in a Fund Manager capacity in other JEREMIE Funds in England that the European Investment Fund (EIF) were also involved with. (At that time, the EIF had the mandate from the European Commission to work with and advise all Member States who were considering the setting up of JEREMIE Funds.)
- As a result of other high level discussions with the EIF at that time, our working assumption was that future ERDF Structural Funds might not be available in Wales due to new Member States from the Eastern Bloc joining the EU. The EIF also expressed the view that looking to the creation of future funds post JEREMIE a potential fund raising would likely only work on a pan-UK basis.
- As a consequence the Board of Finance Wales agreed with the full consent of the Minister to enter into fund management contracts outside of Wales in the North East and subsequently the North West of England.

- The underlying principle of this agreement was that no Welsh funds should be expended outside of Wales and any such contracts would be self-financing or result in a net inflow of funds into Wales.
- Finance Wales created a new subsidiary company, FW Capital Ltd, which then successfully bid under open OJEU procurement rules against other private sector fund managers to manage sub-funds on a profitable basis during 2010/11. These contracts are managed locally using local staff, with oversight from our Cardiff and St Asaph offices. All local costs are covered directly from the fees payable on these contracts with a sizeable additional contribution towards central overheads in Wales.
- To date profits of £1.2m have been earned on these contracts which sit in cash in the FW Capital bank accounts. These monies are freely available to fund Finance Wales' activities in Wales for the benefit of Welsh SMEs and the Welsh Government.
- Further profits are likely to accrue of at least an additional £1m over the life of these contracts.
- In addition to these funds, Finance Wales receives an annual payment of £251k from FW Capital to fund its central overheads for the lifetime of these contracts. This has allowed us to fund and create further employment in Wales for additional Head Office staff without any further call on the public purse in Wales.
- Overall these monies have helped directly to contribute towards the reduction in the annual Grant-in-Aid noted earlier in this submission.
- In addition to these financial benefits, having a presence in these English regions gives the Finance Wales Group the opportunity to identify and then implement in Wales best practice ideas on new funds and support for SMEs – the Performance Bond Fund mentioned earlier is a concrete example of this.
- There are also wider non-financial benefits in strengthening our pools of Non-Executive Directors, co-investors and advisers who can also be introduced to work to the benefit of Wales' SMEs.
- Finally this also strengthens Finance Wales' network of funders and reinforces its relationships with BIS, DCLG, the EIB, and the EIF and of course the British Business Bank.
- This strengthens Finance Wales' reputation as a prudent, commercial investor and puts us in a stronger position to secure further fundraisings, such as those outlined in Q5. This is clearly of great benefit to the Welsh economy and the SME businesses of Wales.

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Appendix 1: **Output Key Performance Indicators**

January, 2014



Appendix 1: Output Key Performance Indicators (KPIs)

Wales SME Investment Fund

KPI's Achieved to 31/12/13					
To: 31/12/13	No. of Investments	No. of Start Ups	Direct Investment (£'000)	PSL (£'000)	Jobs Created/Saved
Actual:					
Equity	4	0	1,547	1,970	33
Mezzanine	11	2	3,668	3,956	152
Loans	23	4	4,343	3,691	556
Total	38	6	9,559	9,617	741
Baseline	55	n/a	9,333	9,333	467
Achievement	69%	n/a	102%	103%	159%
Variance	(17)	n/a	226	284	274

Wales Micro-business Loan Fund

KPI's Achieved to 31/12/13					
To: 31/12/13	No. of Investments	No. of Start Ups	Direct Investment (£'000)	PSL (£'000)	Jobs Created/Saved
Actual	73	28	1,463	1,585	424
Baseline	70	n/a	700	350	70
Achievement	104%	n/a	209%	453%	606%
Variance	3	n/a	763	1,235	354

Wales Property Development Fund

KPI's achieved to 31/12/13						
To: 31/12/13	No. of Investments	No. of Start Ups	Direct Investment (£'000)	PSL (£'000)	Direct Jobs Created	Jobs Safeguarded
Actual	3	0	530	100	20	11
Baseline	5	n/a	3,375	1,013	71	87
Achievement	60%	n/a	16%	10%	28%	13%
Variance	(2)	n/a	(2,845)	(913)	(51)	(76)

Wales JEREMIE Fund

KPI's Achieved to 31st December 2013								
To: 31/12/13	No. of Enterprises	Jobs Created	Jobs Safeguarded	Direct Investment (£'000)	PSL (£'000)	Collaborative R&D	Products, Processes or Services Registered	New or Improved Products, Processes or Services Launched
Equity	60	520	1,084	52,030	76,413	18	20	22
Mezzanine	27	118	564	17,398	26,126	2	0	3
Loans	417	1,414	4,590	50,526	32,932	8	2	16
Total	504	2,052	6,237	119,954	135,471	28	22	41
Baseline	541	3,710	n/a	141,250	149,955	14	18	21
Variance	(37)	(1,659)	n/a	(21,296)	(14,484)	14	4	20
% Achieved	93%	55%	n/a	85%	90%	200%	122%	195%

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Appendix 2: Mid-Term Evaluation of the Wales JEREMIE Fund

January, 2014



oldbell³

Research Policy Analysis
Ymchwil Polisi Dadarsoddi

2000 Celebrating ten years in business 2010
Datlu deng mlynedd mewn busnes

regeneris

ECONOMICS · RESEARCH · ANALYSIS

Mid-Term Evaluation of the Wales JEREMIE Fund

A Final Report by
Regeneris Consulting, Old
Bell 3 and Neil Kemsley



Ewrop & Chymru: Buddsoddi yn eich dyfodol
Cron's Darbygi: Rhanbarthol Ewrop
Europe & Wales: Investing in your future
European Regional Development Fund

Finance Wales, Welsh
European Funding Office &
Welsh Government

Mid-Term Evaluation of the Wales JEREMIE Fund

February 2012

Regeneris Consulting Ltd

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Manchester M1 4DY
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Executive Summary

- i. Regeneris Consulting, with Old Bell 3 and Neil Kemsley, were commissioned by Finance Wales to carry out the mid-term evaluation of the Wales JEREMIE Fund. The evaluation was guided by a Steering Group consisting of Finance Wales, the Welsh Government and Welsh European Funding Office.
- ii. The Wales JEREMIE Fund was the first of its type to be launched in the UK and one of the first in the European Union. It became operational in 2009 and makes available £150 million in loan, mezzanine and equity finance for Welsh small and medium sized enterprises (SMEs). The Fund secured a £75 million loan from the European Investment Bank, a £60 million grant contribution from the ERDF Convergence and Competitiveness Operational Programmes and a £15 million contribution from Finance Wales. The Fund is managed and delivered by Finance Wales, a subsidiary of the Welsh Government.
- iii. The JEREMIE Fund is expected to make an important contribution to the vitality of Wales' base of SMEs. Its primary purpose is to invest in new and established SMEs to produce good commercial returns for the Fund, and generate a substantial legacy fund for Wales. The Fund is expected to support more than 800 businesses over its five year investment period to 2014, to lever in significant amounts of new private sector investment and contribute to the creation of around 15,500 new jobs across Wales.
- iv. The objectives for the evaluation were set by the Steering Group consisting of:
 - (1) An assessment of the continued strategic need and fit of the JEREMIE Fund
 - (2) A comprehensive assessment of the performance of the Fund and prospects over the investment and recovery period
 - (3) An interim assessment of the economic and business impacts of the Fund
 - (4) A review of the adequacy of the governance and management arrangements
 - (5) Recommendations to strengthen the operation and management of the Fund and to guide the future approach to FEIs in Wales.

Main Conclusions

- v. Finance Wales and the JEREMIE Fund have become key assets for the Welsh economy. Finance Wales has established itself as a critical part of the business finance landscape, steadily building a strong profile with an expanding network of intermediaries and a growing reputation as a professional and commercial facing operation. The scale of funding it makes available to Welsh SMEs at a time when the economic climate and conditions in the business finance market are particularly challenging mean that the rationale for its existence has strengthened further since the Fund's development.
- vi. The evaluation evidence suggests that the mix of financial instruments available through the JEREMIE Fund, its investment strategy and its individual investment portfolios are

● Mid-Term Evaluation of the Wales JEREMIE Fund ●

appropriate to the market and the needs of Welsh SMEs. It is underpinned by a clear rationale to correct the market failure in terms of the supply of venture capital on a commercial basis to Welsh SMEs, rather than to provide cheap finance or support business propositions which are weaker/riskier than those that would be acceptable to commercial lenders and venture capitalists in more well-supplied parts of the UK. The investment strategy is enabling the Fund to deliver an investment portfolio which offers the required level of investment risk and reward, but which also recognises its obligations to the European Investment Bank and to the Welsh ERDF programmes.

- vii. The development process for the Fund is assessed as being largely sound and prudent. The exception to this assessment is that the target set for gross job creation in the business plan was set at too high a level. The evaluation recognises that the approach to forecasting job creation outputs, using past achievements of Funds in the Objective 1 programme, may have appeared reasonable at the time the business plan was prepared.
- viii. Overall, the evaluation has concluded that the Fund is being implemented and managed effectively. Investment targets through the first period of its operations have largely been met, while both the investment strategy and the Fund's operations have been adjusted and strengthened in response to emerging patterns of investment activity and performance. By September 2011 the Fund had invested £74m through 493 investments (compared to a target of £70m and 466 investments).
- ix. The overriding message about Finance Wales' approach to the Fund is of an organisation that is committed to lesson learning and improvement. This is recognised by the organisation's network of external partners who have a positive view of the expertise and professionalism of its fund management, and who have been largely positive about its investment decision making process.
- x. Looking forward, the Fund is on target to meet its lifetime investment, realisation and repayment targets. Finance Wales has revised its initial business plan targets and, whilst still subject to much uncertainty, is hopeful of repaying the initial £60m ERDF investment. Whilst Finance Wales is right to be cautious in making these predictions, on balance the evaluation concludes that the Fund's investment and realisations targets are achievable given the way that it has built and manages its portfolio.
- xi. Although most of the investments are at an early stage, there is some evidence that the expected economic development impacts have already started to come to fruition. However, the evaluation has pointed to a need to revisit its job creation target. The target was set at a time when Wales and the UK economy had experienced several years of job growth in an expanding economy. The depth and duration of the current recession has inevitably made many SMEs more cautious about both investment for expansion and recruitment, and the investee survey (and follow-up qualitative research) for this evaluation would seem to confirm this. With three years remaining of the Fund's investment period, this would be an appropriate time to use the evidence of performance to date and the forecast evidence to review the target.
- xii. The market failures that were central to the rationale for the scale and composition of the Wales JEREMIE Fund remain and in some respects have intensified as an exceptional set of circumstances continue to affect SMEs and the financial services sector. The evaluation has concluded that the case for large scale resources will continue to be strong through the

remainder of this ERDF programme and probably well beyond that. Early consideration by the Welsh Government, working with Finance Wales, of successor arrangements to the current JEREMIE project is essential. This needs to continue to emphasise the balance to be struck between providing investment to SMEs to address market failures and delivering economic development benefits.

Recommendations For the Current Fund

- xiii. The evaluation makes a series of recommendations which identify actions that Finance Wales, WEFO and the Welsh Government should consider over the remainder of the Fund's investment period, and which are intended to assist in shaping future access to finance policy. We have therefore grouped the recommendations into those concerned with the operation of the current fund, as well as those which are concerned with broader policy and future delivery issues.

Recommendation 1: Maintain the Focus on the Successful Delivery of the JEREMIE Fund

- xiv. We have concluded that Finance Wales is currently doing a good job in delivering the current JEREMIE Fund. Whilst no major changes are required to the investment and delivery strategy (bar a number of recommendations which follow), there is the need to maintain a clear focus on the successful delivery of JEREMIE Fund during the investment and realisation phases.
- xv. Finance Wales are very much aware of some of the key risks which could undermine this focus, including the following: (i) the challenging economic conditions and the implication in terms of a dampening of future demand for equity finance and the need to ensure a sensible risk profile for new investments; (ii) the increased supply of finance to SMEs in Wales (eg. through the launch of a new SME fund), although these will not start investing until much later in 2012 and the SME fund has been designed to avoid sectoral overlap; (iii) there is also the risk the new Finance Wales funds may divert corporate management and fund management resources away from the implementation of the JEREMIE Fund, although it should be able to adapt effectively having created two new teams serving other UK markets.

Recommendation 2: Retain Flexibility to Respond to SME's Demands for Finance and Related Risks

- xvi. One of the key aspects of the JEREMIE Fund's performance to date has been the strong demand for debt finance, driven to a large extent by the sharp fall in bank lending (though there are signs that there could be a recovery in supply). Whilst demand for risk capital investment held up strongly up to the end of 2010, it has fallen back during the first two quarters of 2011/12.
- xvii. There is no need at the current time to change the balance between loan and equity based investment and indeed the implications of such a step would need to be very carefully considered and justified. However, there is a need to keep a very careful watch on these trends and risks, including a commentary in Finance Wales' quarterly monitoring report to investors. On a related note, if the investment rate is less than expected in the coming years, Finance Wales will need to consider extending the investment period into 2015.

Recommendation 3: Retain Microloans as a Key Element in the JEREMIE Fund

- xviii. Micro-loan finance is critical from the perspective of the Welsh economy and the JEREMIE Fund is a key aspect in the provision of this finance. However, Finance Wales' approach places a strong emphasis on lending money to sound commercial propositions and delivering this in a cost-effective manner, which can be at odds with the aspirations of some partners.
- xix. The fact that WEFO has clarified that the Local Investment Funds (LIFs) cannot be used to match JEREMIE Fund investments is clearly a major issue in terms of stimulating demand for the microloan fund. While it is essential that business owners themselves share the risk of making new investments (and has become a condition of the microloans fund itself), we welcome plans to provide further information on how grant schemes and JEREMIE can make complementary investments in the same business.

Recommendation 4: Establish a Clearer Consensus between Finance Wales and Welsh Government on the Market Failure Finance Wales is Addressing and Improve Communications

- xx. In many regards the relationship between Finance Wales and Welsh Government has been very productive, indeed being an important consideration in the successful approval and launch of the first JEREMIE fund in the UK and one of the first in the EU as a whole. However, there are also a number of respects in which there has been a lack of clarity about the strategic role of Finance Wales and the progress in the delivery of JEREMIE as a key strand of the Welsh Government's enterprise strategy.
- xxi. There needs to be a better shared understanding of the rationale which underpins the Fund's structure and approach to what is both a complex and unusual aspect of economic development policy. Finance Wales needs to more effectively communicate the successes which it achieves in helping to stimulate enterprise, innovation and economic growth across Wales. Welsh Government needs to ensure continuity in its liaison with Finance Wales at a senior officer level, something which is vital to a productive partnership approach.

Recommendation 5: Establish an Accurate Analysis of the Cost Base for the JEREMIE Holding Fund

- xxii. The evaluation has concluded that the annual allowance in the holding fund costs of £900,000 for its share of the costs of Finance Wales plc is an underestimation of true costs of services and support it receives from Finance Wales plc. The allowance appears to be lower than the comparable costs for the English JEREMIE Funds. Finance Wales has already examined this issue and there is merit in reaching as realistic an assessment as possible of what these true costs are. As discussed later in this section, it will help to inform future delivery approaches. Also from an evaluation perspective, this will be particularly helpful in providing a more robust and accurate basis for judging value for money.

Recommendation 6: Make Minor Changes in the Fund's Indicator Set

- xxiii. While the evaluation has not identified a particular need for the Fund to report additional KPIs to the ERDF programmes, there would be some benefit in Finance Wales reviewing how the data it collects is used. Turnover and profit data relating to individual investees is provided prior to the investment decision, and is monitored routinely as part of the Fund's

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work with its portfolio. This would offer both baseline data and could be used to inform simple measures of turnover and profit growth of the businesses supported. However, the rigorous assessment of gross and net measures of the impact on bottom-line business performance (such as turnover, gross value added and profits) will need to be part of the Fund's final evaluation (although the baseline data will inform this).

Recommendation 7: Review the Fund's Gross Job Creation Target

- xxiv. Reflecting on this emerging evidence, we recommend that Finance Wales and WEFO reassess the Fund's lifetime job creation target. This should include a thorough review of the position on monitoring returns from investee businesses to assess the potential uplift in the total associated with returns that currently are not being provided, and an assessment of the extent to which investees that are reporting job creation may see an increase in employment over the remaining investment period and the realisation period. In recessionary conditions, it is reasonable to anticipate some significant lags in the translation of investment into new jobs. Many businesses may well see substantial increases in their order books once conditions improve, with JEREMIE Funds providing a platform for expansion.

Recommendation 8: Annualise KPI Data Collection From Investee Firms

- xxv. A comprehensive set of data for baseline purposes is important if the impacts of the Fund are to be accurately assessed. The Fund should ensure that it is securing the most comprehensive reporting data possible on the number of jobs in investee businesses at the time the investment is made and annually thereafter. Finance Wales has already recognised that its initial approach to the collection of jobs data has not proved effective, and the shift of responsibility to its Investment Executives is part of a process of further tightening its approach to implementation.

Recommendation 9: Review Progress on the Collection and Reporting of Data on the Cross-cutting Themes

- xxvi. It is understood that an Equality Impact Assessment of the JEREMIE Fund has pointed to Finance Wales being effective in meeting its requirements on equality and diversity through its investment activity. Nevertheless, Finance Wales could be more proactive in its approach to the environmental sustainability systems CCT, both in terms of its reporting and monitoring processes, as well as sign-posting investees to suitable specialists providers where relevant. While no target has been set for the CCT indicators, there are sound reasons for Finance Wales to adopt a more proactive approach to pushing the low carbon and equality and diversity agendas.

Recommendation 10: Refocus the Monitoring Reports

- xxvii. To date Finance Wales has produced detailed quarterly monitoring reports to its investors. As the fund evolves, in particular growing its loan book and portfolio of investments, it needs to increase the forward looking aspects of the monitoring report. By the end of 2011/12, the inclusion of a commentary in the monitoring reports on the Fund's income and realisations forecasts (in broad terms), specific provisions and defaults, legacy and KPIs would help give a more rounded picture of performance.

Recommendation 11: Consider Carrying Out Additional Research into Changes in the Welsh Loan Finance Market

- xxviii. It is widely recognised that there is limited accurate data available on the scale, characteristics and pattern of changes in the Welsh debt finance market. Commercial sensitivity clearly plays a part here, since banks and other finance providers tend to be reluctant to share data on their loan books. However, this represents an important gap in the ability of Finance Wales and its partners to assess the case for intervention, to establish the Fund's impacts on the debt finance market and to plan for future interventions. Consideration could be given to carrying out new research, perhaps based on a confidential survey of Finance Wales' intermediary network, to explore the current characteristics of the debt market and expectations about future changes in this market.

Recommendations for Future Funds

Recommendation 12: Recognise that there will be a Need for Public Sector Backed Financial Engineering Instruments in the Future

- xxix. The evidence examined during the course of the evaluation has very clearly demonstrated that there will be a continuing need for public sector backed financial engineering instruments over the course of the next decade. Whilst substantive market failures persist, this must not however be taken as an open-ended demand upon the public purse to fund finance initiatives aimed at SMEs. Public backed funds need to demonstrate their capacity to generate reasonable returns based upon commercial terms.
- xxx. There is continuing uncertainty about the ability of many ERDF backed funds to secure sufficient legacies to enable them to move closer to long term sustainability. Finance Wales is certainly clear in its strategy to establish a sustainable model which enables it to reduce the need for substantial or even any public sector capital support to pump prime new funds on an on-going basis. Indeed, it is taking the necessary steps to secure the cost base, the skills sets and systems and approaches to maximising realisations, which will also support this model. However, it is unlikely to achieve this in the immediate future and the legacy returns it will generate from the Interim Fund, the current JEREMIE fund and the new SME Fund, will be vital in generating the capital necessary to underpin a sustainable model in the future.

Recommendation 13: Begin the Development and Delivery of a Future ERDF Backed Fund

- xxxi. There remains a lot of uncertainty about the next ERDF Structural Fund programme, how it will apply in Wales and the ways in which support for financial engineering instruments such as JEREMIE might be pursued through the ERDF regulations. Subject to this uncertainty, we believe that there are very good reasons for Wales to pursue an umbrella fund (or fund of funds), which could again offer the potential economics of scale benefits of a large and coherent investment fund, as well as efficient investment mechanisms and fund management services. However, the ability to achieve a similar fund size to the current JEREMIE fund would depend crucially upon the involvement of other major investors such as the EIB.

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- xxxii. The development of a preferred approach is complex and we suggest Welsh Government, which leads in this policy area, work with Finance Wales as a key practitioner in SME funds to inform the development of future financial engineering instruments.
- xxxiii. If there is to be a successor to the current JEREMIE Fund on a similar scale, there is a strong case for all key aspects of fund management and delivery to be competitively tendered whatever model is eventually adopted. Whilst this will have merit in driving efficiency and value for money for the public sector, it will also stimulate other private sector providers to look to Wales for new opportunities. In the context of a JEREMIE type fund this approach would involve the competitive tendering of both the holding fund and fund management activities. However, if the holding fund activity is to be tendered, it is vital that this strand is completed at an early stage, including the provision for the appointed holding fund manager to undertake the substantive fund development activity and the procurement of the fund managers.

Recommendation 14: Review the Future Revenue Grant Funding of Finance Wales

- xxxiv. As highlighted earlier, one of the conclusions from the evaluation is that whilst the rationale for the provision of revenue funding from Welsh Government to Finance Wales is clear, the way in which this supports the operating costs of the current JEREMIE fund is far less clear. In general, it is considered good practice to have clarity in terms of the provision of public sector revenue grant funding and the range and scale of outputs which are being delivered in return. But also, if a more market led approach is to be adopted to the commissioning of future holding fund services, there will be the need for clarity on the fee structure and associated terms for the provision of these services. The revenue grant provided to Finance Wales for any on-going services it provides on behalf of Welsh Government would need to be revised in light of this arrangement.

Recommendation 15: Remain Mindful of the Lessons and Good Practice in Developing and Implementing Financial Engineering Instruments.

- xxxv. The lessons and aspects of good practice in the design and implementation of public sector backed financial engineering instruments need to be taken into account in designing and delivering any new FEIs. There needs to be clarity in terms of the skills and expertise required to design a new fund, including business development, corporate finance, and economic development policy, delivery and funding.
- xxxvi. Many of these skills reside with Finance Wales, and the relationship between WEFO, the Welsh Government and Finance Wales which has steered the development and delivery of the JEREMIE Fund to date, should have an important part to play in shaping future arrangements.



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Access To Finance Review - Stage 2
Response of the Board of Finance Wales plc
December, 2013



Introduction

This is the Finance Wales plc Board Response to the Professor Dylan Jones-Evans Stage 2 Report, released on 12th November 2013.

The Response that follows comments on the four key areas identified within the Report, namely Banks' Lending Patterns to SMEs, Alternative Sources of Funding, Finance Wales and the Development Bank for Wales.

1. Banks' Lending Patterns

Essentially the content here is largely an update on the previous Stage 1 Review releases in June 2013 and incorporates data from the SME Monitor Quarter 2 review and the British Bankers Association, Banks' support for SMEs – Quarter 2, 2013 review. These reports contain high level data on lending in Wales and related data on interest rates where available.

As the comments on the data are largely factual and in the public domain, we have no specific comments to make on this aspect of the Review.

We would endorse the view that the Banks are taking a tougher stance on lending to SMEs generally, in particular in how they assess risk and value available collateral. In practice we have seen no substantive evidence of the Banks returning to the SME marketplace, apart from selectively for fully secured lending into the corporate end of the market, i.e. SMEs with turnover levels of £25m and above.

We have seen no examples of the High Street Banks lending unsecured to SMEs or in a subordinated position, the two core market areas that Finance Wales ('FW') has always looked to support in its agreed role as a "gap funder".

2. Alternative Sources of Funding

We endorse the comments made on the strong availability of invoice discounting and other asset based lending.

On informal investment (pages 25-27) our comments on the role of Business Angels and xénos are set out below.

The report suggests that Wales should emulate the Scottish business model embodied in LINC Scotland to raise informal and especially angel investment levels in Wales. It makes a recommendation for an equity guarantee scheme for angel investors as a way of stimulating angel investment in Wales. It also discusses various other initiatives that are currently holding back angel investment such as the need for Due Diligence, investee company preparation and a Welsh Angel Co-Fund.

On the specific recommendation for an equity guarantee scheme this needs to be considered in respect of the current tax incentives provided under the various UK Government schemes to encourage angel investment, in particular the Seed Enterprise Investment Scheme (SEIS) and Enterprise Investment Scheme (EIS) HMRC schemes. These schemes are driving angel investment in the UK and if angels were to utilise an equity guarantee scheme then they would not qualify for SEIS and/or EIS. It is recommended that discussions with HMRC are held before implementing such a scheme.

Levels of angel investment in Wales are lower than in Scotland. The reasons for higher levels in Scotland are many, including the private wealth creation generated by the oil and gas industry and lack of competition for angel funds from neighbouring regions. LINC is the equivalent of the UKBAA as a national organisation of which xénos is one of 24 members. Comparing xénos activity levels with LINC's is like comparing one of LINC's members with all their membership. LINC also includes HALO the Irish (North and South) angel network so the statistics are not just related to Scotland.

However, the Report does address the question of how angel activity in Wales can be increased. The range of proposals in the report (p26) is to be welcomed and xénos agrees with most of them. The move towards syndication in the Welsh angel market is not as strong as in Scotland or England and where it happens xénos has been the instigator. So the proposal to encourage small groups of angel investors (syndicates) may not be so appropriate in Wales.

The report asks if xénos should change its operational model. xénos has sought to continue to respond to its various client groups – companies seeking funding; investors and professional advisers. It has changed accordingly as well as moving towards a more commercial model to ensure its longevity. Most importantly the xénos model of collaboration with other networks to increase deal making, working with a specialised fund to offer gap funding and more proactive approach to investors has resulted in the Network responding to change and increasing its completion levels by nearly 3 fold. It is continuing to develop to meet changing market demands and the recent Dragon Fund is an example of this. The Report's recognition of the importance of the informal market is to be welcomed, and xénos sees itself as being an important contributor to the development of this funding sector in Wales for the foreseeable future.

On Venture Capital (VC) there are some misleading comments on Finance Wales investment team's links with other VCs (p28). In practice very few VC teams have "formal" relationships with one another unless via a joint venture agreement which are very rare in the industry. The vast majority of linkages are at a personal level.

These are then manifested in co-investment on a deal by deal basis and our Annual Review (issued to the Access to Finance Review and now attached here as an Appendix) incorporates details of a selection of these firms. As noted in the Review (p 28) we do have a Memorandum of Understanding (MOU) with Fusion IP, which has recently been renewed. Fusion is one of our key co-investors in venture capital in Wales with seven companies where we are co-invested. We also have regular meetings with and have agreed an informal arrangement to refer deals to and from the Business Growth Fund (BGF). It should be noted that many VCs no longer operate in the early stage pre-revenue space which Finance Wales operates in (e.g. 3i, Amadeus etc.), thus this is a relatively small tight knit group anyway, where Finance Wales plays a prominent role in Wales.

Turning to Peer 2 Peer Lending and Crowdfunding, we agree these are rapidly growing areas and becoming a key part of the alternative investment marketplace. In recognition of this we have held a number of discussions with many of the existing players during 2013 and in October, we launched an in-house review of how Finance Wales can address this emerging market. Finance Wales is looking at the possibility of creating a suitable internet platform for both equity and lending products and has

commissioned an independent review to inform its thinking which will be available in January 2014.

We have already proposed to the Minister in October 2012 the possibility of creating an Entrepreneurs' Fund of £5m and a Technology Seed Fund of £7.5m. The latter is now incorporated in the FTR Funding recently agreed.

3. Finance Wales

For ease of reference we summarise our views under separate headings:

Finance Wales' Strategy and Remit

There are comments in the Review (p39) suggesting that there has been a "change of direction from the original focus" which seem misplaced. Whilst the Review refers to the initial Finance Wales mission statement in 2001 (p39), it makes no reference to the current governing document that now covers our remit – the Management Arrangement. This was originally drafted in 2006 when the direct ownership of Finance Wales moved from the WDA to the Welsh Ministers. The first paragraph of the General Purposes and Aims (section 3.1) states that -

'The Company shall be managed as a group of commercial development funds to provide businesses in Wales with flexible and sustainable finance for their development. Its activities seek to address market failure in this area and stimulate new investment by the private sector'

This document has been regularly reviewed by Finance Wales and the Welsh Government since then, most recently in June 2013 and no changes have ever been made to this primary objective. Moreover each year Finance Wales submits a formal Business Plan to the Welsh Government setting out clearly the core strategic aims of Finance Wales for the coming year. The Chairman meets with the Minister regularly to ensure alignment with Welsh Government policy and to consider new initiatives. A further example of the alignment of its execution capability and flexibility is the latest 'Help to Buy' residential shared equity housing scheme which has been swiftly launched on a very tight timeline by Finance Wales in conjunction with the Housing and Regeneration Department. We therefore do not follow and indeed refute the assertion of a change of direction, particularly on any kind of a unilateral basis. The same section of the Review (p39/40) suggests that Finance Wales became "focused on developing itself as an independent fund with its role as an arm of the Welsh Government becoming a secondary issue." This is pure conjecture on the part of the Author of the Review and has no basis whatsoever. Similar language of "reluctance" and "reticence" appear later on the same page and elsewhere as well as in the previous June Review, without any evidence to support such assertions.

The question of 'independence' has only ever applied to investment decisions which are properly made at arm's length from the public sector (this has been enshrined from the outset in all Finance Wales' investment activities).

'Independence' should also not be confused with our efforts to become self-financing which in 2010 were in response to a reduction in the direct Grant in Aid from the Welsh Government (£5.1 million in 2011/12 to £4.1 million in 2013/14) and the uncertainty of securing future funds either from Europe or from the Welsh Government. The Finance Wales Board therefore initiated a plan, which included cost reductions, operational

efficiency improvements and the pursuit of additional sources of income. These measures were still aligned with our remit of providing commercial funds in a sustainable way.

The prospects for a future JEREMIE Fund in Wales were very uncertain and the need to raise private funds in the future seemed likely. This led to the pursuit of Fund Management opportunities outside Wales which were intended to establish a track record which would assist in raising funds for Wales in the future (and contribute to central costs thus enabling our activities in Wales to continue at the same and subsequently increased levels despite the reduction in Direct GIA from the Welsh Government). In the current financial year the Direct Grant is now £2.891m. It is important to note that these activities were staffed and funded locally and did not detract from our activities in Wales.

Independence in terms of ownership of Finance Wales or a reclassification only arose in 2009/10 when, in consultation with the Welsh Government, options were being considered to enable Finance Wales' borrowings to remain off balance sheet. Once this situation was resolved no further discussions around a change of ownership or reclassification took place.

Elsewhere the Review correctly states that "money with management" was considered to be an important element in improving investment opportunities in Wales, but incorrectly states that "this approach was quietly discontinued several years ago." In fact, those support programmes (e.g. Access to Capital) and the associated staff and financial resources were transferred to the Welsh Government following a Strategic Review of Finance Wales which was undertaken when ownership of Finance Wales was transferred to the Welsh Ministers in April 2006. These programmes continue today in Business Wales.

In our view therefore Finance Wales has, since 2005/06, pursued a sustainable commercial strategy which has driven the investments we have made and the interest rates charged, in full agreement with and consent from the Welsh Government, as noted by the Minister in her response to the Review on 12th November.

There has been no change in strategy and we simply do not accept the allegation (p43) that there is "evidence of reluctance by Finance Wales to fully embrace its role in supporting SMEs and economic development in Wales and its apparent confusion over its commercial ambitions with its development responsibilities." Our track record of raising £363million in Funding, (comprising £108m from the Welsh Government/Finance Wales, £100m from ERDF and £155m from the private sector); investing over £268m in Welsh SMEs; creating and safeguarding over 32,000 jobs and leveraging in circa £443m of private sector leverage, tells a very different tale.

Cost of lending to SMEs

This is the one part of the Review that appears to have attracted most attention in the media and in Plenary and has been the subject of further press articles published by the Author of the Review in recent days. This is a pity as it detracts from the main thrust of the Review.

Having said this, it was very clearly a key area to be reviewed and in contrast to the High Street Banks, Finance Wales willingly made available to the Review a very large

amount of data on every one of the 1,713 loans made by Finance Wales since 2001. This included amount, date, term and interest rate. We also provided full detail of our current pricing matrix and details of our approach to risk pricing, although for understandable reasons of confidentiality we did not allow this to be published in the Review itself.

Unfortunately this data has only been used selectively in the Review and does not properly reflect the totality of Finance Wales' approach to pricing loans. We appreciate that the assessment of a suitable risk premium and the judgement of the value of collateral and Loss Given Default (LGD) ratios are a highly complex and in some cases esoteric matters, but most senior bankers and accountants will recognise that these are an integral part of any financial institution's risk pricing.

Much is made of the impact of EC Reference Rates (see a fuller analysis of these under State Aid Considerations below) but what has been overlooked is that like any other financial institution, the constituent parts of any pricing matrix for loans comprise three ingredients. These are (i) the cost of capital, (ii) the collateral rating, and (iii) the risk premium (LGD).

Whilst the Review acknowledges that in Finance Wales' formal response to the Minister on Part 1 of the Review (p33), Finance Wales made the point that its interest rates reflect that it adopts a greater tolerance towards higher risk SME lending and as a result incurs higher default rates. This acceptance is not borne out in the subsequent commentary, which to all intents and purposes chooses to ignore the risk premium argument (the LGD). This despite footnotes on pages 36-38 referring to what the LGD actually is.

As we stated in our submission most SMEs fall into the lower risk ratings (p37) and generally offer low or nil levels of collateral. These two ingredients comprise to form the basis of the risk premium.

The suggested rates put forward by the Review itself at 4.99% (p38) suggest a 100% level of collateralisation and a higher end SME rating of "BB". In practice Finance Wales usually lends with nil-50% collateral and most SMEs fall into either the lower B or CCC rating, suggesting Finance Wales' current average rate of 10% is in line with acceptable market rates and properly reflects the risk premium.

Moreover if we were to move to lower interest rates as suggested and maintain viable and sustainable funds, we would need to move to a tighter risk appetite and would not be able to support the riskier end of the SME spectrum at a BB rating or lower. This would potentially disenfranchise a large group of businesses that we are currently supporting. We have considered this and believe that we would need to tolerate loan defaults of no more than 5% as compared to the current budgeted levels of 10% to sustain an equivalent Fund performance (see also below under Future Options). We are aware that other respondents to the Consultation exercise have independently commented on this aspect and it is perhaps better for their views to be heard and considered alongside the comments contained here.

Equally relevant is the fact that Finance Wales' two main investing Funds – the Wales JEREMIE Fund and the Wales SME Investment Fund have 50% backing from the European Investment Bank (EIB) and Barclays respectively. The financial models on which their lendings are based includes a base case forecast of 10% fixed interest

rates throughout the life of the banks' loans. Both Banks have set financial covenants based around these rates and the corresponding defaults. Any material variation in the financial models, as proposed, would therefore very likely require the consent of these funders and would materially reduce their perceived comfort with the ability of the funds to repay their obligations. These loans are legally binding contractual arrangements and any material changes such as those proposed in this Review could put these arrangements at risk. In the case of the ERDF funding in JEREMIE this would also threaten the perceived "legacy" funds to be returned to allow future investment in the next generation of SMEs once the EIB is repaid. We have calculated that to reduce average interest rates by 5% across the Board in a similar £60m JEREMIE Sub Loan Fund would reduce the "legacy" of the Loan sub fund by circa one third from £27.5m to £18.5m.

These are important considerations as any reduction in interest rates as proposed could reduce the availability of both matched private sector funding, and possibly legacy EC funding in the future, to support future funds such as a JEREMIE 2 Fund to the detriment of Welsh SMEs.

There is also the question of value for money in respect of public money and the issue of securing an appropriate commercial return for the taxpayer as a stakeholder from public/private backed funds.

The implications for future funds are covered in more detail later in this submission.

State Aid

This is a complex area but the comments within the review regarding GBER and De Minimis are misleading and inaccurate. We have instructed Eversheds to prepare an overview of these aspects and this is attached as an Appendix to this submission. This overview comments in some detail on the EC Reference Rates issue and the GBER and De Minimis issues and fundamentally disagrees with many of the comments in the Review.

It is also worthy of note that as with the question of interest rates, the current investing funds operate under contractual obligations with very different State Aid arrangements which cannot be unilaterally changed without reference to the Commission. The Wales JEREMIE Fund operates under a formal State Aid Notification as the Author of the Review is aware. The Wales SME Investment Fund operates under a MEIP arrangement based on an independent consultant's review. As noted in the Eversheds' overview (sections 4.7 and 4.8), Finance Wales cannot "unilaterally start providing subsidised loans because by doing so it would be in breach of various obligations it holds".

Equally relevant is the current updated State Aid Risk Guidelines and the latest revised draft GBER guidelines, both due to be implemented in June 2014. These make clear reference to a requirement that all "investments are profit driven" and the Fund should operate "a commercially sound investment strategy". Neither of these appears compatible with the proposals outlined in the Review.

4. The Wales Development Bank

Whilst perhaps conceptually attractive to some respondents on a macro level, as with previous proposals earlier in 2012 from both the Welsh Conservatives and Plaid

Cymru, the practical implications of such a proposal throw up far-reaching complications. Amongst these are regulatory issues, the possible need for a banking licence, capital adequacy requirements, conflict management and state aid considerations.

These are highly complex issues which will clearly take several months to be considered and worked through with the appropriate authorities if this approach is accepted as a viable change of direction.

Of more practical immediate consideration is the fact that all Finance Wales' existing funds are subject to legally binding obligations with third parties, as noted above which run to 2017 and beyond. Similarly the new Business Wales structure was also only set up in January 2013 under contractual arrangements, which we believe to run for three years.

The suggestion that all of these can be transferred across to the new Bank, needs much further careful and considered reflection in our view. No one could easily argue against the 5 Principles proposed by the Review (p8) although the key phrase in Principle 1, on the issue of access to funding is, in our view the words "every **viable** business". There are clearly very differing views between a commercial investor/lender and a purely economic investor on what constitutes a viable business.

If the Development Bank does wish to provide risk graded B-CCC SMEs with lower interest loans than Finance Wales currently supplies, then where would the matched private funding be found? The likelihood is that the Welsh Government would need to write a very large cheque from public funds to achieve this goal. The Review's references to other countries providing such Subsidised funds do not mean that the Welsh Government will necessarily wish to do similarly and this deserves careful consideration as to value for money considerations let alone State Aid matters.

5. Future Options

As we have noted above to implement some of the changes in the Review would be extremely difficult for the existing Funds on a number of levels.

We have summarised some of the approximate financial "costs" of operating a loan fund at lower average interest rates of 5%. This could well make it extremely difficult to raise matched private bank loans at the current leverage levels of 50%. This would suggest additional public money would need to be committed – perhaps 60% or slightly higher, which could lead to State Aid issues in itself.

Some form of interest rate subsidy outside of the Funds might be a possible solution under some form of de minimis state aid arrangements (perhaps a Funding for Lending (Wales) Scheme), but again this could still fail a state aid test as outlined by Eversheds and could cost an additional circa £9m for even a modest fund of £60m based on the models we have run as outlined above.

We should also recognise that we are currently in an exceptionally low interest rate environment; with nearly all economic forecasters suggesting that base rates will likely return to their long term average of 5% by 2016 or earlier. This will coincide with the launch of follow-on funds such as JEREMIE 2 and will need to be factored into any assessment of the likely costs of such a scheme.

Over the past 2 years Finance Wales, under its existing structure, has successfully conceived and delivered a number of new initiatives for the Minister, such as the Wales SME Investment Fund, the Wales Micro-business Loan Fund and the Wales Property Development Fund, as well as the development of new roles as Sector Ambassadors within the Finance Wales Group. The current structure of Finance Wales operating funds for the Welsh Government at arm's length, but providing independent commercial investment decision making, has proven highly flexible and allows State Aid compliant funds to be created to deliver valuable economic development outputs.

6. Conclusions

This Review brings a useful external perspective on the challenges of the access to finance for SMEs, as the Minister has noted in her statement on 12th November. As such it is to be welcomed. However, it is disappointing to the Board of Finance Wales that many of the statements contained in the Review are based largely on misconceptions of the current role and remit of Finance Wales and misunderstandings of the risk based considerations that any lender or investor in the real world needs to take into account.

We believe that Finance Wales has faithfully followed its remit from the Welsh Government in recent years and has delivered both viable and sustainable funds for Welsh SMEs with a level of risk appetite that generally exceeds that of the Banks and other funding providers. We remain fully committed to supporting the growth and development of Welsh SMEs as part of the Welsh Government's economic development plans, by developing commercial funds with both public and private sector capital. We also continue to look for innovative ways to deliver funding as our recent submissions to the Financial Transaction Reserve and our future plans to develop a potential peer to peer/crowdfunding platform for Welsh SMEs have demonstrated.

Finance Wales already has/does many of the things that are proposed for the Development Bank e.g. it is a regulated business already; it has successfully leveraged private sector funds at the fund and at the deal level; it does attract capital to Wales that would not otherwise be here, acting as a gap funder, etc. and there is clearly scope to build on this without the time consuming and costly creation of a wholly new organisation (which is indeed acknowledged in the report).

The Board is committed to working with the Minister and her officials to ensure that the activities of Finance Wales remain relevant to Wales and to exploring new opportunities.

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National Assembly for Wales

Finance Committee Inquiry – Finance Wales

Response of the Board of Finance Wales plc

Appendix 4: Finance Wales Group Corporate Structure and Governance

January, 2014



Appendix 4: **Finance Wales Group Corporate Structure and Governance, as at January, 2014**

The Group

Finance Wales plc. is a wholly owned subsidiary of the Welsh Ministers acting through the Welsh Government. The Finance Wales Group is comprised of Finance Wales plc., a number of subsidiary companies and a joint venture (see Annex 1).

The Finance Wales Group provides fund holding and fund management services targeted at supporting small to medium sized enterprises (SMEs).

Companies within the Group operate the Wales JEREMIE Fund, the Small Loan Fund, the Rescue and Restructuring Fund, the Wales SME Investment Fund, the Micro-business Loan Fund, the Life Sciences Fund, the Wales Property Development Fund and Help to Buy - Wales.

Finance Wales Investments also manages and provides portfolio services for various funds including the Wales JEREMIE Fund, the Wales SME Investment Fund, Wales Micro-business Loan Fund as well as Technology Commercialisation Centre, the Wales Creative IP Fund, the Finance Wales Investment III Fund, the Objective 1, Objective 2 and Objective 2 Transitional Funds.

There are two funds which are managed by fund managers outside the Group namely the Wales Life Sciences Investment Fund managed by Arthurian Life Sciences Limited and £1m of the Micro Loan Fund which is managed by the Wales Council for Voluntary Action (WVCA).

xénos – The Wales Business Angels Network Limited which introduces investors to businesses seeking growth funding is operated by Finance Wales.

FW Capital Ltd is authorised and regulated by the Financial Conduct Authority. This part of the Group is responsible for managing a £17 million equity fund in the North East of England, £10 million Tees Valley Catalyst Fund and loan and mezzanine funds totalling £45 million in the North West of England.

Governance

Although Finance Wales plc. is not required to comply with the UK Corporate Governance Code issued by the Financial Reporting Council the directors are committed to applying the underlying principles of the Code, having regard to the size of the company.

Board of directors

The Board consists of a non-executive Chairman and five non-executive directors, together with two executive directors, the Chief Executive and the Director of Finance and Administration, as listed below:

Ian Johnson – Chairman	Sian Lloyd-Jones – Chief Executive
Ivar Grey	Margaret Llewellyn OBE
Clive John	Kevin O’Leary – Director of Finance & Administration

Huw Morgan

Christopher Rowlands – Senior Independent Director

The Board meets regularly in addition to an annual strategy review. A Board performance and evaluation process is in place. It is an internal exercise based on an evaluation questionnaire which is conducted by the Chairman and Senior Independent Director. Succession planning and strategic input to exit activity were highlighted as areas for specific focus over the last twelve months. This process is itself reviewed by Mazars, as Internal Auditors to provide an independent check.

The Board of directors have a variety of professional backgrounds with relevant skills and experience. The Board receive monthly management information in respect of the Group's financial and non-financial performance. It is the role of the Board to challenge the information provided and ensure that it is fit for their purpose. In accordance with the Management Arrangement an observer from the Welsh Government or their alternate attends all Board meetings and is provided with information as it is disseminated to Board members.

Board Committees

The following Board committees have been set up, each with its own terms of reference, procedures, responsibilities and powers:

Audit Committee

The Finance Wales Group Audit Committee comprises two non-executive members:

- Mr Ivar Grey (Chairman)
- Mrs Margaret Llewellyn OBE

The Audit Committee's duties include inter alia:

- To review the effectiveness of the group's internal control and risk management systems.
- To ensure that adequate processes and mechanisms are in place for the management of risk.
- Reviewing the scope and results of work of both the internal and external auditors.
- Reviewing the annual financial statements and related policies and assumptions.

The Audit Committee meets quarterly. It is normally attended by the Chief Executive and the Director of Finance and Administration together with the internal and external auditors, the Welsh Government Department for Business, Enterprise, Technology and Science Group Finance Director and the Senior Corporate Governance Manager.

In addition to the quarterly meetings the Audit Committee also has private meetings with the management, internal and external auditors at least once a year.

Feedback on the business of the Audit Committee is given to the Board and the minutes are circulated to the Welsh Government Corporate Governance Committee.

Remuneration Committee

The Remuneration Committee comprises two non-executive members:

- Mr Clive John (Chairman)
- Mrs Margaret Llewellyn OBE

The Remuneration Committee is responsible for advising the Chief Executive and the Board on matters relating to recruitment and remuneration policies, and reporting to the Board as necessary.

The Chief Executive and HR Consultant normally attend the Remuneration Committee.

Nomination Committee

The Nomination Committee now comprises all members of the Board. The Nomination Committee is responsible for matters relating to identifying and nominating candidates for Board vacancies and for the process of recruitment of both executive and non-executive directors.

Valuations Committee

The Board has recently established a Valuations Committee which is comprised of members of the Senior Management Team. The purpose of the Valuations Committee is to assist the Board in fulfilling its oversight responsibilities in respect of the valuation of assets and legacy forecast.

Conflicts Committee

The Conflicts Committee is comprised of two non-executive members and one executive member of the Board. The purpose of the Conflicts Committee is to ensure that Finance Wales has appropriate procedures in place for managing conflicts of interest in accordance with financial services best practice.

Investment Committee

The Investment Committee oversees investment related activities for all funds on behalf of Finance Wales companies in accordance with the Investment Operating Guidelines and respective Facility Agreements. It considers recommendations for investments of in excess of £500k.

Internal Control

Responsibility for the management of the risks relating to the operations of Finance Wales lies with its Board of directors. The directors acknowledge that they are responsible for the company's system of internal control and for reviewing its effectiveness.

Additionally the Chief Executive has personal responsibilities analogous to those of the Accounting Officer of a public body. These responsibilities are detailed in the Management Arrangement. This includes responsibility for reviewing the effectiveness of the system of internal control. Her review of the effectiveness of the system of internal control is informed by the work of the company's internal auditors who operate to Government Internal Audit Standards. They submit regular reports, which include

their independent opinion on the adequacy and effectiveness of the company's system of internal control together with recommendations for improvement.

Finance Wales has in place its own Risk Management Policy and Risk Register. The individual risks contained in the Finance Wales Risk Register have been consolidated into a Finance Wales Strategic Risk Map which is reviewed regularly by the Senior Management Team, Audit Committee and Board. The company's risk management arrangements have been approved by the Board and key risks are brought to their attention on a regular basis.

Financial risk management objectives and policies

The principal business of the company is investment and, as such, exposure to and management of portfolio risk is an inherent feature of this activity, particularly given the area of the market in which the company operates. The current economic climate provides significant challenges for such funds which the company continues to address in a managed way.

Finance Wales operates a series of rigorous processes to ensure the probity and quality of all investments made, including internal or external due diligence as required. Certain appropriate individuals have delegated authority to sanction lower value investments, beyond which they are sanctioned by the Investment Committee which meets on a regular basis. The Group's current internal auditors, Mazars and external auditors, Deloitte, appraise investment activity both by way of sampling individual investments and at the corporate level as part of the statutory accounts preparation.

The Wales JEREMIE Fund, which has the bulk of current funds available for investment is also subject to scrutiny by the Welsh Government's European Funds Audit Team (EFAT).

It is also worth noting that all the processes were subject to diligence by Finance Wales' private investors such as Barclays Bank and the EIB, and they form part of Finance Wales' contractual obligations to these stakeholders. This diligence also includes such matters as setting the investment operating guidelines and other internal control mechanisms. The activities undertaken by FW Capital Limited are also subject to regulation by the Financial Conduct Authority.

The Group's activities expose it to a number of financial risks including cash flow risk, credit risk and liquidity risk:

- **Cash flow risk:** The Group, borrows funds and subsequently lends to companies, makes use of appropriate hedging policies where necessary, to mitigate the risk of interest rate exposure. Interest-bearing assets and liabilities are held at fixed rate to ensure certainty of cash flows.
- **Credit risk:** The Group's financial assets are bank balances and cash, loan receivables and investments. The credit risk is primarily attributable to its loan receivables. The amounts presented in the balance sheet are net of allowances for doubtful debt. An allowance for impairment is made where there is an identified loss event which, based on previous experience, is evidence of a reduction in the recoverability of the cash flows.

The credit risk on derivative financial instruments is limited because the counterparties are banks with high credit-ratings assigned by international credit-rating agencies. There is no significant concentration of credit risk as its exposure is spread over a large number of counterparties and companies.

- **Liquidity risk:** In order to maintain liquidity to ensure that sufficient funds are available for on-going operations and future developments, the group uses long-term debt finance.
- **Counterparty risk:** The Company recognises this as a significant risk given the general instability exhibited by financial institutions in recent times. The Company has adopted a Treasury Management policy to address this risk and takes steps to ensure that any cash held, is in a range of institutions who meet the bank rating criteria set out in the policy.

Relationship with External Governance Bodies

Welsh Government Corporate Governance Committee

Copies of Audit Committee minutes are routinely provided to this committee. An annual governance statement is also provided, which highlights the work that has been carried out during the year.

Financial Conduct Authority (FCA)

Both FW Capital Limited and the staff who undertake regulated activity are required to be approved by the FCA. As a regulated body FW Capital is required to submit monthly, quarterly and annual reporting requirements to the FCA. Our external auditors are also required to provide a statement of compliance to the FCA confirming compliance with the rules or guidance during the preceding twelvemonths and where appropriate any remedial action.

The National Crime Agency (NCA)

Given the financial nature of the work undertaken by Finance Wales and the number of businesses it engages with, there is regrettably a high potential for fraud and money laundering to take place. Whilst the appropriate level of pre investment diligence is always undertaken, it remains difficult to eliminate any chance of financial crime. Accordingly all members of staff are trained to recognise any signs of potential financial crime. The Group has a designated Money Laundering Reporting Officer (MLRO) whose responsibility is to liaise with the individual raising any suspicion and make a report to NCA as required.

Office of Fair Trading (OFT)

A number of Finance Wales' subsidiary companies hold consumer credit licences. Accordingly the Money Laundering Regulations 2007 apply to those businesses and their supervisor is Office of Fair Trading ('OFT'). The OFT have powers to take enforcement action where appropriate against Finance Wales if it fails to put in place the required anti-money laundering system and controls, or fails to register with the OFT when required to do so. They also have powers to prosecute and to impose civil financial penalties.

As part of the UK Government's programme of regulatory reform for financial services, the Financial Conduct Authority will take over regulation of consumer credit from the Office of Fair Trading on 1 April 2014. This brings the conduct of business regulation under a single financial services regulator.

As part of the transitional arrangements a number of Finance Wales companies have registered for 'interim permission' and will be applying for full permission to carry on regulated credit activities in due course.

ENDS

Finance Wales Group - Oct 2013

