

# **A FEASIBILITY STUDY INTO THE CREATION OF A DEVELOPMENT BANK FOR WALES**

**A report to the Minister for Economy, Science and Transport  
from the Development Bank for Wales Task and Finish Group**

**March 2015**

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## INTRODUCTION

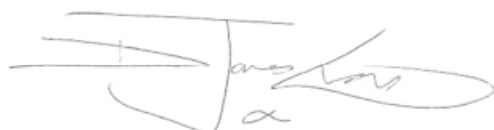
This report presents the deliberations and conclusions of the Task and Finish Group established by the Welsh Government to examine the feasibility of establishing a new Development Bank for Wales.

It has been an exhaustive and comprehensive process during the last seven months with contributions from all of the members of the group on their respective areas of experience and expertise. It is this detailed work that forms the foundation for this report.

I would therefore like to extend my sincere thanks to the following individuals who served on the Task and Finish Group and contributed to this report: Katy Chamberlain, Patrick Crawford, Nelson Gray, Robert Hunter, Juliet Luporini, Roger Maggs, Christopher Nott, Richard Pepler, Tim Pezzack, Mark Rhydderch-Roberts and Seth Thomas. I would also like to express my gratitude to Rhidian Morgan of the Welsh Government for his valuable administrative support and Dr Tianshu Zhao for her excellent and groundbreaking research into the state of finance for SMEs in Wales.

It is the view of the Task and Finish Group that the current solutions being provided by Finance Wales, as a subsidiary of the Welsh Government, will not be able to fully address the challenges in closing the widening funding gap for SMEs in Wales. Therefore, we recommend that a new organisation - the Development Bank for Wales - be established that will enhance the capability of the Welsh Government to support SMEs in Wales. It will do so by working more closely with the private sector to address the supply and demand dynamics of the Welsh finance market as well as developing its own innovative approach to provide solutions that directly address the needs of the SME sector.

By benchmarking itself against global best practice, the creation of the first public regional development bank in the UK could be the catalyst and driving force in revolutionising the way that finance is provided for Welsh businesses and, as a result, create further growth within the Welsh economy. Given this, we hope that the Welsh Government will carefully review the findings of this report and act upon our recommendations.



Professor Dylan Jones-Evans OBE  
Chair, Development Bank for Wales Task and Finish Group.

# EXECUTIVE SUMMARY

## Background

- A Task and Finish Group was appointed by the Minister for Economy, Science and Transport in June 2014 to produce a report on the possible form, function and feasibility of a Development Bank for Wales (DBW).
- It identified that a number of market gaps need to be addressed in the provision of finance to Welsh SMEs and that there is a geographic bias regarding the availability of bank credit, informal investment and venture capital to businesses in Wales.
- Unfortunately, much of the public sector response within Wales has been undertaken largely in isolation from the private sector and has not taken account of market changes that has led to limited funding from the banks to SMEs. There is also room to improve the utilisation of private funding in the form of informal investors and venture capital to boost high growth firms that can have a disproportionate effect on the economy.
- Therefore, it was concluded that not only is government involvement warranted to support SMEs but also the existing intervention in Wales needs to be reviewed and its efficiency improved.

## What is the Development Bank for Wales?

- A range of different options has been examined as to how the Welsh Government could deliver this intervention. It has concluded that the current provider - Finance Wales - should not take this role in the future.
- Instead, it is proposed that a new institution - the DBW - should be created with some of the functions of Finance Wales integrated into this organisation. This would be the first regional development bank in the UK and could have a significant impact on the Welsh SME sector.
- The DBW will follow a hybrid model where the primary focus will be on addressing market failure in key sectors of the SME community by working more closely in partnership with key stakeholders to deliver a wider range of financial products and services to Welsh SMEs. However, the DBW will also be able to manage its own funds including those currently under management by Finance Wales or developed in partnership with other organisations.
- It will therefore focus on closing the funding gap and help deliver finance to Welsh SMEs including charitable, community and social enterprises in a cost effective manner. It will directly address the supply and demand dynamics of the Welsh SME finance market, will be flexible in developing solutions that address

market needs, is able to mobilise Welsh and external financial sources, and is aligned with business support providers.

- This will require an organisation that is built around a business model, structure and culture that needs to respond to a very different set of market dynamics when compared to the challenges that were faced by Finance Wales. It will also provide a more holistic approach and thus enhance the capability of the Welsh Government to support SMEs in Wales.

#### **What are the principles behind the DBW?**

- The public sector should not displace the private sector but address a market failure in the provision of finance to SMEs.
- Viable businesses in Wales, including those in the social sector, should have access to appropriate and affordable funding.
- The primary role of government-backed funding for SMEs is to drive forward economic development.
- Business support should be offered alongside financial support to businesses rather than as separate elements.
- Funding solutions should be customer-oriented and reflect the needs of SMEs at different stages of growth.
- There should be stimulation of demand for business finance within the SME community.

#### **What will the DBW do?**

- Focus on the provision of finance to microbusinesses (0-9 employees) in Wales given the growing importance of this sector for employment.
- Work with private sector to fill the funding gap by providing the finance that will enable the banks to overcome collateral, or affordability issues and lend to Welsh SMEs.
- Address gaps in the awareness and provision of invoice financing to SMEs in Wales.
- Create a Welsh Angel Capital Association to act as an umbrella organisation to encourage the development of multiple angel groups and networks.
- Boost investment into high growth and innovative firms by outsourcing venture capital to a network of specialist funds and establishing a network of micro-venture capital funds with regional and sector focus.

- Ensure that the products of UK Export Finance are marketed effectively within Wales so as to drive forward internationalisation in the economy and the benefits of higher efficiency that exporters competing in a wider market can obtain.
- Support the use of alternative finance as well as encouraging public finance providers to seek investment opportunities in Wales.
- Give social sector organisations guidance and sign-posting support to providers of advice on how to become ‘investment-ready’ and work with other funding providers to address any market gaps.
- Ensure that financial support through the DBW is fully aligned with Welsh Government business support functions.
- Develop a strategic research and development function that will enable the DBW and the Welsh Government to understand the SME sector in Wales and to deliver the products and services required.
- Have an active outreach programme that will build relationships with key stakeholders in the business, finance and social sector community, including the provision of financial training and support for businesses and intermediaries.
- Provide subsidised consultancy support to supplement existing programmes, especially to those businesses that have been identified as needing to strengthen their management team if the funding they receive is to be fully maximised for the benefit of the business.
- Stimulate business demand in the marketplace by acting as a catalyst in promoting new business development and growth in Wales as well as supporting businesses through acting as a signpost to different types of funding mechanisms.
- Ensure there is positive engagement with key stakeholders through connecting positively with politicians, civil society, the media and others as well as ensuring there is growing Welsh visibility with external financial providers and public bodies.

## **1. INTRODUCTION**

1. In January 2013, the Minister for Economy, Science and Transport commissioned an independent review into access to finance for SMEs in Wales. The aim of the review was to examine how effectively SMEs in Wales were served by existing sources of funding, identify areas of particular challenge and provide recommendations for action. Two reports were published in June and November 2013 examining these areas. In addition, the Finance Committee of the National Assembly for Wales (NAfW) undertook a more focused examination into the role of Finance Wales, which was published in May 2013.
2. The Access to Finance review concluded that similarly to the rest of the UK, SMEs faced difficulties in accessing finance within Wales. It estimated that there remained a funding gap of around £500 million in the provision of funding to SMEs from mainstream finance organisations such as the banks. Evidence from the review also indicated that the current government response to supporting SMEs to access finance in Wales was not adequate to fill this gap and it was therefore recommended that the Welsh Government examine the feasibility of establishing a Development Bank for Wales (DBW) as a vehicle that would draw together the various sources of public sector funding in Wales and utilise these more efficiently alongside private sector finance solutions.
3. In June 2014, the Minister established a Task and Finish (T&F) Group to explore the form, function and feasibility of a DBW. This has included an examination of closer ties between the Welsh Government's financial support offer and the business support regime, as well as securing greater levels of private sector funding, potentially both debt and equity, to support businesses in Wales. This should include attracting new investment into Wales.

### **1.1. The Economic Case**

4. Over the last six years, lending to SMEs has fallen as various restrictions have been imposed on, and developed by, the banking sector in the UK in response to the 2008 financial crisis and its aftermath. Whilst the UK economy has recovered during the last three years, various reports show that bank lending has not kept pace with the growing economy. Similar to other studies on funding SMEs, the Welsh Government's access to finance review has detailed the continuing decline in bank lending to businesses in Wales. More recent data suggests that the situation remains broadly the same with a significant proportion of those businesses that are seeking finance from high street banks being refused facilities.
5. The lack of funding available from the financial sector for small and medium-sized enterprises (SMEs) is known as the "funding gap". This occurs when the



private sector funders are unwilling to accept certain risks that they deem too high, have relatively high transactions costs, and the benefits are not sufficient to cover the cost incurred, and when it cannot capture the full economic and social value of its investments. They may also be unable to accept certain risks because of internal limitations or regulations. This can result in SMEs with viable projects being systematically constrained from receiving external finance to maximise their potential and contribute to economic output; and in such circumstances, government intervention to address any under-investment or market failure would be warranted.

6. The intervention of government cannot only be justified solely on the grounds that it is better placed than the private sector to intervene to address market failures. It must also show that in the long term, the intervention could lead to a greater development of SMEs in terms of the innovation, job creation and dynamism of economic growth.
7. In addition, the role of government should not be focused only on providing money to fill any funding gap. Instead, it should be working together with private sector to nurture and promote an underserved market through a disciplined and targeted involvement of public intervention within the market gap that is carefully identified and evaluated.
8. Part of the role of any future solution by the Welsh Government would be to address the funding gap in the market-place i.e. the difference between the funding required by SMEs and the funding available from the private sector. Using a combination of data from the British Bankers Association (BBA) and the SME Monitor, the Access to Finance review estimated that the funding gap for SMEs in Wales was approximately £500 million.
9. Other reports have estimated the funding gap for the UK from which the level in Wales can be extrapolated. Deloitte's analysed long-run survey data of SMEs in 2012 in preparation for the British Business Bank and estimated there to be a gap in the provision of finance to UK SMEs of around £5 billion but that by the end of 2017, this figure could rise to about £22 billion. Assuming that this is proportionately applied to Welsh SMEs, the funding gap would have been about £200 million in 2012 but would rise to around £800 million by 2017.
10. During its review of Finance Wales, the NAFW Finance Committee requested a more detailed estimate of the funding gap and an updated examination of new data was undertaken for this report (the detail was provided in a separate paper to the T&F Group). This research estimated the funding gap in Wales to be a minimum of £240 million or a maximum of £749 million. This would place the mean funding gap at approximately £500 million, similar to the original estimate from the Access to Finance Review.
11. Can other sources of existing funding fill this gap? According to the presentation from the British Business Bank (BBB) to the T&F Group, its various

programmes supplied £28 million of support to Wales in 2013-14 (although it would be expected that the volumes supported under the Enterprise Finance Guarantee programme of the Department for Business Innovation and Skills form part of the bank lending figures in the BBA data).

12. In addition, Finance Wales provided £33 million of investments in 2013-14 with a further £2.3 million facilitated by xénos, the Wales Business Angel Network. Whilst some have suggested that the alternative finance market could fill this gap, best estimates of the current impact of this new and growing sector shows that around £44 million of funding is currently coming into Welsh SMEs.
13. With 80 per cent of the funding gap remaining (£400 million), one of the key objectives of the DBW would be to ensure that this is reduced through relevant interventions if it is to contribute to the growth and development of the Welsh economy.
14. Therefore, the key question for the Welsh Government in considering a specific intervention to support the finance needs of Welsh SMEs, including those in the charitable, voluntary, community and social enterprise sectors, is whether the situation in Wales is the same as for the other parts of the UK or if there is a case for greater public involvement to ensure that Welsh SMEs get access to finance to enable them to become more competitive and make a stronger contribution to the growth of the Welsh economy.
15. An examination was made of the situation regarding debt funding (which is largely supplied by the banks) and equity funding (which comes from informal investors and venture capital). If specific areas can then be identified where intervention may be justified, this will enable the Welsh Government to consider the delivery of specific actions that can close the funding gap for SMEs in Wales.

## **1.2 Debt funding**

16. The Access to Finance review noted the difficulties in gathering detailed data on funding provided by banks to SMEs in Wales. Currently, the only survey that undertakes a regular analysis of this is the SME Monitor, which has been gathering information on the finance requirements of SMEs since 2011. As part of this work, a detailed analysis of this data for Wales was undertaken and a separate paper presented to the T&F Group. This shows that:
  - SMEs in Wales have a high likelihood of applying for overdrafts (including both new overdraft and renewal of the existing ones) compared to SMEs in England (but not Scotland). Regarding applications for bank loans/commercial mortgage, SMEs in Wales have higher application rate than for those in England and Scotland. This suggests a greater dependency on bank funding in Wales than other parts of the UK.

- SMEs in Wales face a higher degree of bank credit constraint compared to their counterparts with similar characteristics in England and Scotland i.e. they face a higher likelihood of being an unsuccessful applicant. As a result, owners of SMEs in Wales have a higher probability of having to inject personal funds into the business because the firm has tried unsuccessfully to obtain bank finance or has assumed that the bank would not lend to their business.
  - SMEs in Wales have a higher probability of being rejected for both overdrafts and bank loans as compared to those in England and Scotland. Also, Welsh SMEs that were offered smaller amounts of funding than they applied for are more likely to be offered an amount more than 50 per cent lower than requested. This failure in the market place suggest there could be a role for government in working with the banks to close this funding gap for SMEs in Wales.
  - SMEs in Wales are more likely to be discouraged from applying for a bank overdraft or bank loan even though there is a need by the business. This is mainly due to concerns over rejection and a perception of the reluctance of banks to lend. There are also issues over the security requirement (collateral) and terms and condition associated with borrowing, as well as the affordability of overdrafts.
  - SMEs in Wales are more likely to report a negative impact of not seeking an overdraft/bank loan facility especially as there is a greater need for funding as compared to SMEs in England and Scotland. Analysis of this data also suggests that SMEs in Wales face higher degree of bank credit constraint relative to England and Scotland, and a shortage of alternative external financing channels.
  - SMEs in Wales that are younger, smaller, have a higher risk rating, have new bank credit or are first time applicants have a higher rate of rejection for funding from the banks. Also applications for bank term loans are rejected more often than those for bank overdrafts. In terms of industry sector, manufacturing, construction and wholesale/retail firms seems to have a higher degree of bank credit constraints. Given the disadvantage of being new or small when applying for a bank loan, it is not surprising that applications below £25,000 have the highest rate of rejection for both overdraft and loans. This clearly suggests that the high street banks are not adequately serving those Welsh firms - start-ups and microbusinesses - that require finance.
17. This geographical bias in bank lending is not unusual given the inherent spatial basis for the availability of bank credit to SMEs in a branch banking system. Research has shown that the closeness of physical distance between borrowers and the branches of national banks eases the interaction between

the loan officers at local branches and SMEs and can reduce default risks for lenders materially. A centralised branch banking system together with the use of mechanical credit scoring models in assessing the creditworthiness of SMEs in lending works against that benefit.

18. The competitiveness condition in the local market will also play a role since it would influence how loan officers in banks would act in such circumstances. An analysis of the characteristics of banks' credit market at a regional level shows that it is characterised in Wales by high concentration, a low density of branches, and the longest functional distance, which implies a lower willingness and lower capacity of national banks in supplying lending to SMEs in Wales. This is consistent with the highest credit constraint faced by Welsh SMEs as revealed in the analysis based on SME Monitor.
19. This detailed analysis of two different datasets shows that there is a geographical bias in terms of the provision of finance to SMEs in Wales compared to England and Scotland. This suggests that the banks need to increase their funding to Welsh SMEs although this seems unlikely given recent historical data from BBA on bank lending to SMEs from 2011-2014 which show that the overall value of bank facilities approved in Wales has fallen by £1.1 billion since 2011 with loans accounting for 84 per cent of that decline. It would have been expected, given tighter credit and collateral regulations within banks over this period, for lending to smaller firms (with less than £1 million annual turnover) to fall and the overall value of approved loans to this group indeed declined by £157 million.
20. Medium-sized firms (that have a turnover of between £1 million and £25 million) have also experienced difficulties, with the overall value of loan facilities falling by £758 million. This indicates that all categories of SMEs in Wales are finding it difficult to secure funding from the high street banks and that this situation is unlikely to change in the future.
21. The decline in bank facilities also suggests that current public sector solutions that have been established to support firms that have been refused bank credit are not addressing this issue sufficiently and that the Welsh Government may need to develop or promote alternative sources of funding in the private and public sector.

### **1.3 Equity funding**

22. The Access to Finance Review has examined the level of informal and formal investment into Wales through business angels and venture capital firms respectively. Further updating of this information shows the following information.

23. The latest data on the Enterprise Investment Scheme (which serves as a proxy for angel investment) shows that for the period 2010-13, 200 investments were made in Wales with a value of £48.2 million (£20.8 million in 2012-13). This equates to 2.8 per cent of the UK total by number and 1.9 per cent by value. Only Northern Ireland and the North East of England have performed worse than this during this period.
24. With regard to the Seed Enterprise Investment Scheme (SEIS), only 10 investments were made in 2012-13 with a total value of £400,000. This was the lowest average investment of any of the UK regions.
25. British Venture Capital Association (BVCA) data on equity investments in the UK shows that there has been a decline in the number of equity investments in Wales since 2008. In 2013, Wales attracted £55 million of equity investment into 25 companies i.e. 3.7 per cent of all UK investments but only 1.3 per cent of the value of those investments. Of this, only £9 million was invested into venture capital with £42 million into expansion projects. On a comparative basis, Wales had 0.13 investee companies per 1,000 of total VAT registered businesses, half of the level for the UK and the lowest of all UK regions.
26. During the period, 2009-2013 Finance Wales invested venture capital in only 9 start-up companies as compared to 340 start-ups across the UK by BVCA members. On a population basis, Finance Wales invested in three start-ups per 1 million head of population whilst for the UK the figure is 5.5 start-ups.
27. Despite the perceived gap in equity-based funding to Welsh firms, there have been very few investments by British Business Bank backed venture capital funds in Wales, with only £1.3 million of equity investments going into Welsh SMEs in 2013-4 (1 per cent of the total invested in the UK).
28. Since the Business Growth Fund was established in 2011 to support equity investment into businesses, there has only been one investment into Wales as compared to fourteen for Scotland.

#### **1.4 Conclusions**

29. Analysis of the data on both debt and equity finance indicates there are a number of major market gaps that need to be addressed.
30. The first is the provision of finance requests of less than £25,000 that the current providers are largely rejecting. This means that there needs to be a focus on helping both new firms and microbusinesses to access funding and support.
31. Welsh firms are also likely to be offered less than they need for their business, suggesting that direct interventions could be developed in partnership with the

banks that can overcome some of the issues associated with a lack of sufficient collateral and affordability of the loan. This would especially be pertinent for larger SMEs that have seen their approved loans fall by £157 million since 2011.

32. Informal investment through business angels is lower in Wales than expected and more could be done to stimulate this vital source of private sector funding. Similarly, venture capital investment into start-ups remains below expectations and could be limiting the development of high growth firms that can create wealth and employment in the economy.
33. Therefore, the data indicates clearly that government intervention is warranted. However, it also suggests that the existing government intervention in Wales needs to be reviewed and its efficiency improved.

## **2. STRATEGIC CASE**

34. Given the presence of a funding gap and the reduction in bank financing to Welsh SMEs, the T&F Group is of the opinion that there are six options for the Welsh Government to consider with regard to the way forward to support the financial needs of SMEs in Wales, two of which are variations on the current institutional model operated in Wales and two of which are new approaches.

### **2.1 OPTION A - No Welsh Government support**

35. One of the priorities of the Welsh Government is to “strengthen the conditions that will enable business to create jobs and sustainable economic growth”. Currently, the Welsh Government provides grants, loans and equity to businesses either directly or through Finance Wales as part of its strategy to achieve this aim.
36. The Welsh Government could withdraw from the supply of funding to SMEs in Wales and leave this to the private sector. However, the Access to Finance review (which examined the current situation regarding the supply of finance to SMEs by both the private and public sector in Wales) identified a considerable funding gap in the supply of finance to SMEs in Wales, a finding that has been reinforced by the data presented earlier in this study. This gap is currently not being met by existing providers.
37. More importantly, there is not only clear evidence of a continuing contraction in lending to SMEs (especially new firms and micro businesses) but that the situation in Wales is worse than for both England and Scotland. In addition, there is evidence that equity funding needs further stimulation to encourage more high growth firms.

### **2.2 OPTION B - Part of the British Business Bank**

38. Rather than becoming directly involved in funding SMEs, the Welsh Government could seek a solution through the auspices of the British Business Bank, which could set up a division in Wales. Whilst this looks attractive, there are a number of political and economic obstacles to this approach.
39. Devolved responsibility for economic development (including the funding of SMEs both directly and via European Structural Funding) would mean that any Welsh element of the British Business Bank could not fall directly under the remit of the UK Government.

40. The strategy adopted by the British Business Bank, where wholesale funds are allocated to intermediaries that then distribute these to SMEs, may not be the best approach to supporting SMEs in Wales, especially as evidence presented to the T&F Group showed that the venture capital funds supported by the British Business Bank have made a negligible impact in Wales.
41. In addition, the data analysis in the last section shows that the status of the existing financial structure in Wales is weaker than other regions and there may need to be a direct regional intervention to nurture the market, as this cannot be done by the UK Government alone.
42. There is a clear recognition that microbusinesses need to be supported in Wales and yet this is one area where the British Business Bank has yet to intervene despite the success of the Start-Up Funds scheme.
43. The T&F Group is supportive of using guarantees as a form of flexible funding instrument to ensure that any funding gap identified by the banks can be addressed for the benefit of SME clients although such instruments have yet to be developed by the British Business Bank, with the historical exception of the Enterprise Guarantee Scheme (EFG).
44. Under current circumstances, the BBB may not be the best vehicle to deliver financial solutions to SMEs in Wales. However, it is critical that the Welsh Government (and any body it currently manages or develops in the future) should work closely with the British Business Bank at both a strategic level but also to deliver specific solutions for Welsh SMEs. So how should the Welsh Government deliver public funding to businesses in Wales?

### **2.3 OPTION C - Maintain the status quo.**

45. In Wales, the majority of the funding currently provided to SMEs by Welsh Government and its subsidiary Finance Wales is provided directly to the final beneficiary in the form of grants, loans and equity. An exception is the £100 million Life Sciences Fund, which is currently managed by an independent organisation, Arthurian Life Sciences, on behalf of Finance Wales and the Welsh Government.
46. The creation of Finance Wales since 2001 has made positive contributions in terms of providing funding to Welsh SMEs. However, it can be argued that there has been a reluctance to respond to the changing environment for SMEs since the financial crisis of 2008 and a disinclination to create radical, proactive, and scalable financial solutions in the market place to support Welsh business.
47. There has been uncertainty, beyond its simple key performance indicators, of what its role should be, both within the organisation itself and within its parent, the Welsh Government. As the NAFW Finance Committee suggested, Finance



Wales has not been as transparent as it could have been which impacts on issues about overall accountability.

48. While there is interaction between Finance Wales and other parts of SME support within the Welsh Government, there is considerable room for improvement in ensuring that SME clients are able to benefit from both financial support and business advice.
49. There was also evidence in the Access to Finance review that some private sector providers had begun to perceive Finance Wales as a direct competitor rather than fulfilling the role of a market gap funder. In addition, most of Finance Wales funding is done without working with the existing private sector, which can result in information opaqueness, low efficiency and low return.
50. These matters are now gradually being addressed but there is a concern that the activity still focuses almost solely on providing a financial solution on its own rather than providing a wider solution that encompasses both financial support and business advice.
51. There is concern from the evidence produced that Finance Wales does not, in its current form, have the strategic direction and operational ability to be able to develop new approaches that will make a step difference in the funding of SMEs that is required within Wales. As a result, keeping Finance Wales in its current form would potentially result in limited change to the current provision by the public sector.
52. That is not to say that some of the functions of Finance Wales should not be amalgamated into a new financial body with a different strategic remit. In fact, the T&F Group concurs with the conclusions of the NAFW Committee that any changes to Finance Wales should utilise some of its existing skills and infrastructure.
53. This option of maintaining the status quo could only be feasible if the Minister believes that the short-term costs of change in keeping Finance Wales in its current form outweighs the longer-term benefits of a more coherent and comprehensive strategic solution. However, this would require continued government subsidy as Finance Wales has yet to break even financially as an organisation.
54. It is the opinion of the T&F Group that the government provision of access to finance is too important a priority to be left within the narrow remit of this institution that has failed to adapt sufficiently to changing market conditions.

## **2.4 OPTION D - Enhanced Finance Wales**

55. This approach would enhance the role of Finance Wales by maintaining its current fund management role but adding such functions such as research, financial institutional relations, and the provision of more integrated business support. This has the benefit of allowing 'business as normal' and adding new capabilities. The major problem is that this solution fails to address the issues discussed earlier that are at the heart of Finance Wales namely effectiveness, efficiency and public responsiveness.
56. In addition, the current structure of Finance Wales means that it has been organised as a fund manager; it would be difficult for it to outsource any functions whilst also taking on additional responsibilities as part of a new strategic approach deemed necessary to deliver what is needed for Wales. There seems to be very little ethos that is geared towards the economic development role of the organisation that would need to be a priority for any new SME finance body in Wales.
57. Members of the T&F Group have shown concern over the high costs associated with the management of loan funds, and the approach taken with regard to equity funding in Wales. This would not be expected to change under any enhanced body with the same mission and remit.

## **2.5 OPTION E - Full in-house provision**

58. This would be a fully integrated financial organisation with in-house provision of financing and business support. This would be similar to development bank models elsewhere such as Canada and the USA where financial and business support are provided by the same organisation.
59. This may be an expensive model to implement at a time when there is reduced public funding available, especially in ensuring that a whole suite of funds relevant to the needs of SMEs across Wales are developed and serviced accordingly.
60. By providing funding directly to businesses without directly addressing a market failure and in competition with the high street banks and other alternative finance providers, there could be a risk of crowding out existing private sector providers. The role of a public sector funding entity should not be to replace private sector funding but to generate greater investment. Simply lending money to businesses by government directly does not necessarily generate any additional private sector leverage.
61. While there may be potential efficiencies to gain in bringing in business support under the auspices of a new body, in terms of scale and outreach, the extent of Welsh Government business support under the Business Wales brand

may be too wide to sit easily within the Development Bank. In addition there could be concern that changing the Business Wales brand or integrating it directly into a new organisation, may place business support at risk given that it has begun to establish itself in the marketplace

62. The creation of what some would perceive essentially to be a similar model to Welsh Development Agency, albeit with a strong finance function, may not be politically palatable. However, the T&F Group felt that such an organisation could be developed in the future but at this stage, other options are easier to implement to deal with the financial issues facing SMEs.

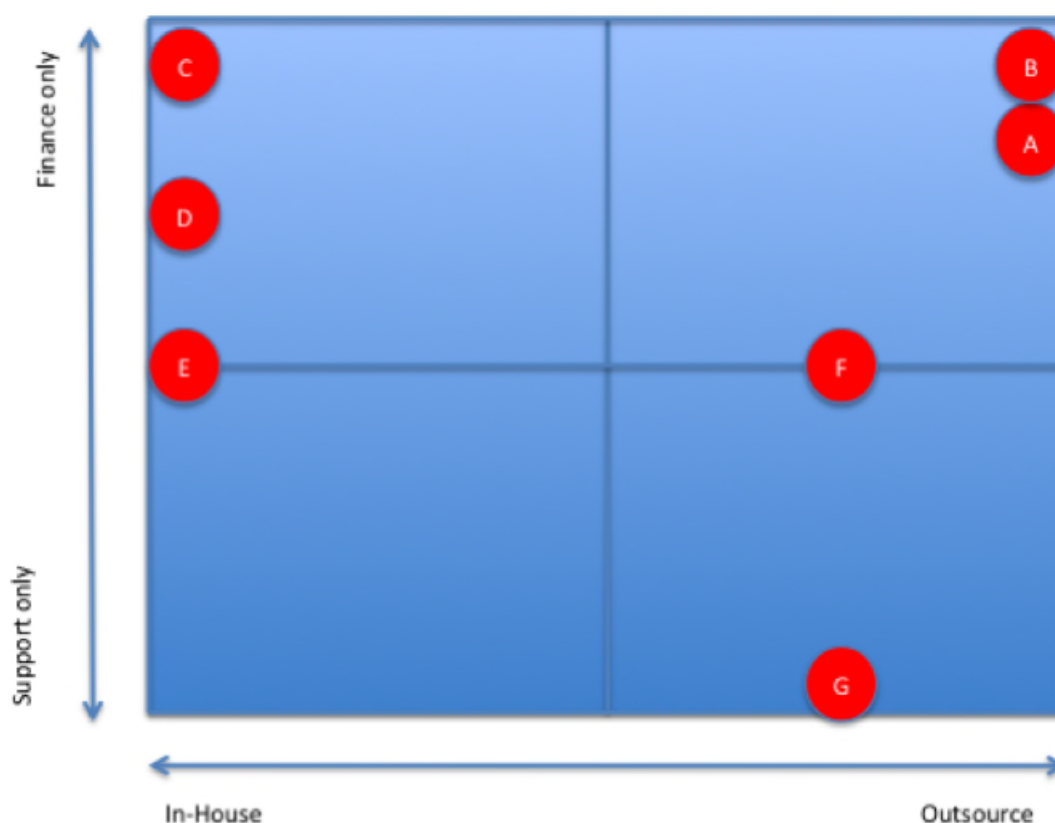
## **2.6 OPTION F - Hybrid provision.**

63. As with the British Business Bank, the consolidation of all access to finance schemes into one institution in Wales creates the opportunity to build a new organisation that becomes a strong brand that Welsh SMEs will see as the 'go to' location for financial support.
64. In order to be efficient and effective, it is proposed that where possible, such an organisation should not only deliver its own funds if necessary but also work with private intermediaries to deliver its programmes.
65. Unlike the British Business Bank that is only a wholesale institution, the degree of involvement of the public sector may vary according to the type of financial intervention required. This could range from outsourcing all equity financing to private venture capital organisations, to acting in partnership with banks to provide gap funding to existing SMEs, to utilising the existing business support mechanism to deliver funding to microbusinesses.
66. The new entity could also work in partnership to support and enhance alternative sources of funding, especially invoice finance, and act as a catalyst in developing a strong business angel network in Wales.
67. If Finance Wales were to be merged or amalgamated into a new body, then consideration would need to be given to the management of its existing funds.
68. The hybrid model would allow the Welsh Government's current policies to be implemented whilst, at the same time, reducing the costs of due diligence, attracting higher levels of private sector leverage and enabling public sector funding to be targeted at those products and services which can have the biggest benefit to the Welsh SME community. Therefore, the aim of the hybrid model is not to crowd out the private sector but to work with it to ensure that the most appropriate funding is provided to Welsh SMEs.

## 2.7 Conclusions

69. This hybrid approach is the preferred model where the primary focus would be on working more closely in partnership with key stakeholders to deliver a wider range of financial products and services to Welsh SMEs. The entity should also, if necessary, be able to manage its own funds; these could include those currently under management by Finance Wales or developed in partnership with other organisations.
70. This is a major change in the approach currently taken by Welsh Government directly or through its subsidiary Finance Wales but will enable the public sector to maximise the impact it can have on supporting the SME community in Wales, in a potentially cost effective manner (subject to full cost comparisons).
71. There are potentially negative impacts from this approach but these can be minimised through the experiences of the British Business Bank in undertaking the same process with Capital For Enterprise Ltd, and the Welsh Government's amalgamation of the Welsh Development Agency and other bodies.
72. Figure 1 below shows the different options available to Welsh Government along with (G) Business Wales.

Figure 1. Options for supporting SMEs in Wales



### **3. THE ORGANISATIONAL CASE**

#### **3.1. Characteristics of a Development Bank**

73. The evidence suggests that a new organisation should be created to manage the public funding of SMEs in Wales that should be along the lines of a public development bank (PDB).
74. A PDB is a state-owned financial institution whose mandate is to promote socioeconomic development by financing specific economic activities, sectors, or segments. This can include public participation in the financial system and/or providing financing for projects considered valuable for economic development or that are key elements of national public policy.
75. If a PDB is to be set up in Wales to undertake such a role, then consideration must be made of how they operate in other countries to ensure that best practice is adopted. Consideration needs to be given to a number of key issues in how a PDB might work in Wales including mandate, targeted market segment, positioning vis-à-vis the private sector, financial sustainability, pricing policy, key performance indicators and how the PDB is financed.

#### ***Mandate***

76. It is critical that a PDB's mandate and resources are properly framed relative to the government's strategy within that public policy domain and the PDB's own legal foundation.
77. A clear mandate will not only guide the scope of activity undertaken by the PDB but will also act as a benchmark against which performance should be monitored and assessed whilst allowing for flexibility at the operational level. The Access to Finance Review and the NAFW noted that there has been no clear mandate for Finance Wales and this has led to confusion over its role.

#### ***Targeted market segment***

78. The determination of the targeted market segments should be dictated by the analysis of market failure in the finance market for SMEs and its primary causes. A clearly defined and focused target market enhances the transparency of the PDB and facilitates oversight over the operation of the PDB. Unfortunately, Finance Wales has not targeted parts of the SME market and has instead managed general funds that do not provide any specialised support to deal with aspects of market failure. As will be discussed later, this has been most prominent in its support for equity funding support.

79. The scope of the PDBs activities must also fit its resources (including both financial and human resources). Given the heterogeneous nature of the SME market, there is need for defined assessment of the market gap and subsequent prioritisation that should focus on those segments whose development has more substantial implication for the government's long-term economic strategy. Given that the market gap can change according to the economic and business environment, it should be subject to a periodic review and update.

### ***Positioning of the bank***

80. In terms of positioning, the targeted market segment should also be guided by the extent to which government has an enabling tool to attract the participation of the private sector to the segment. To ensure maximum impact from PDB operations and minimise possible distortions, the ideal positioning of a PDB is to act complementarily with the private sector, a strategy that is consistent with the pro-market activism view of public intervention.
81. Public intervention in the SME market via a PDB should avoid both a "deadweight" effect, when the beneficiary from the public intervention is a SME which would have survived and grown in any case; or a "substitution effect", where the SME would have exited the market in the absence of the intervention.
82. In the former case, providing support to businesses that can obtain finance from conventional sources ties up government resources that could be used to support viable businesses that cannot obtain finance. That is why the public sector should not compete 'head to head' with the private sector in the supply of funding to businesses. The latter case not only wastes scarce public resources but also distorts market selection process and harms the positive spillover effect of new business formation. This suggests the significant importance of the evaluation of the viability of business in the provision of financial support by the PDB. It also highlights that the evaluation of the performance of SMEs receiving financial support from the PDB should be one of crucial performance indicators in the evaluation of its effectiveness.

### ***Financial sustainability***

83. While the PDB's main objective is not to maximise profit, any mandate should ensure that the PDB achieves self-financial sustainability over time. A development bank without financial self-sustainability would pose fiscal risk for the government and create a threat towards a commitment of public intervention. Despite reducing the Welsh Government subsidy from £5.5m in 2010 to £3.5m in 2014 Finance Wales is still some way off achieving financial self-sustainability.
84. The requirement of financial sustainability in the mandate would incentivise the board of directors and management team of the PDB to utilise the financial

resources efficiently and conduct management professionally. The board of a PDB that is not financially sustainable is more likely to request periodic subsidisation and recapitalisation from the government, compromising its independence. Financial sustainability will need to be defined (maintenance of capital, rate of return, return on capital, cost/income ratio) and the time period to be taken to achieve it needs to be specified in any business plan for the PDB.

### ***Pricing policy***

85. In order to maintain a break-even situation as described above, the cost of borrowing charged by a PDB to SMEs in the provision of debt finance should, on average, be the sum of the funding cost, the operating cost, and the risk premium (covering the default of principal). In a case where there is a requirement for an explicit positive return on capital, the mark-up to support the return should be an additional variable to take into account.
86. It is natural to compare the pricing policy of the PDB and that of the private sector in order to establish the extent to which the presence of the PDB improves the affordability of debt finance for SMEs. The spirit of pro-market activism requires the PDB to operate at the market gap that is underserved by private sector with the greatest negative impact being faced by SMEs is when the external finance market for SMEs does not exist.

### ***Key performance indicators***

87. To hold the PDB accountable to its mission, the mandate should make provisions for reviewing its performance on a short-term, medium term and long-term basis. As the ultimate goal of PDBs in promoting SME the finance market is to contribute to long-term economic development through facilitating access to external finance, the SME's development objectives should be included in the key performance indicators for its assessment.
88. Regarding the definition of development objectives, these should be directly linked to the efficiency of the allocation of financial resources toward the productive activities (i.e. outputs) rather than the quantity of the allocation (i.e. inputs), i.e. the main focus should not be on the number and value of investments but on the return from that investment or the number of jobs created.
89. The key policy concern should not be on the aggregate levels of inputs, but how resources (inputs) are allocated to support activities that raise productivity since those are more relevant parameters for economic development. The traditional measurement of development objectives of public intervention such as the targeted investment rate and targeted number of deals over-emphasises the quantity of financial support by the government and has contributed to the low efficiency of public intervention.

90. At a micro-level, the evaluation of the performance of the SMEs who received financial support from the government should also be measured to ensure that the development objectives of PDB are translated into policy and processes at the operational level.
91. This requires a commitment to research and evaluation by the PDB. It would also help to distinguish the tangible progress attributable to the intervention the SME firm has received from those that would have happened without public intervention.
92. Moreover, the development objectives should measure the extent to which:
  - The activity is incremental to that provided by private intermediaries
  - Private intermediaries have increased their market share in the segment where the PDB is active (i.e. demonstration effect)
  - The PDB has organised training or other non-financial assistance activities to improve business and professional skills (i.e. transfer of skills),
  - The PDB improves environmental and social awareness.

### ***Financing the PDB***

93. There are several ways in which a PDB can be financed, including (a) receiving budget allocations from the government, (b) borrowing from other financial institutions, (c) raising money in the domestic or international capital markets, and (d) taking savings and deposits from the public.
94. Like all other public financial institutions, PDBs are endowed with a certain amount of equity capital by public authorities when they are founded. After the initial injection of equity by government, the next step is to create leverage from non-governmental funds to maximise the PDB's impact. Most PDBs resort to market financing while only a minority are solely funded through public equity endowments. Since a PDB is owned by government bodies, public guarantees, either in an implicit or in explicit manner, would enable them to borrow in the capital market at a yield that is slightly higher than gilts but less than corporate bonds.
95. Raising funds from public debt markets can be viewed positively since this would improve the quality of the management of PDB and the clarity of its financial performance due to market discipline, increasing the accountability of its directors. The information transparency and disclosure required for the fund raising in the public debt market should result in less government interference and increased external monitoring in the activities of PDBs. Raising such funds may be an option in the future for a development bank in Wales but is unlikely in the short term given the restrictions on public borrowing by the Welsh Government although this should certainly be explored once the bank is operational.



96. Finally, there are PDBs that raise deposits from the general public. Most institutions of this kind are retail banks and normally have strong ties to a particular region, primarily delivering financial services within that geographic area. Some have argued that PDBs should avoid taking deposits from the general public so that they focus their operations in the asset side, avoiding competition with private banks and limit potential taxpayers' exposure to liability management-related losses.
97. The distinction between a development bank and a commercial bank might become blurred when PDBs are allowed to offer savings and deposits accounts to the general public. Unless their mandate is related to fostering savings, preventing capital drain from poorer to richer regions, or enhancing the payment system in certain market segments, retail funding should generally be outside the scope of PDBs because it imposes additional challenges in management, transparency, and supervision. Again, this would be unlikely for a new body in the short term given the regulatory hurdles to achieve this in Wales.

### **3.2. Principles for a Development Bank for Wales**

98. The T&F Group believes that six principles should form the core for any changes to the current way in which Welsh Government supports access to finance for the SME community.

#### ***Addressing a market failure.***

99. The public sector should not displace the private sector but address a market failure in the provision of finance to SMEs.
100. Government access to finance schemes should be targeted at correcting an identified market failure, ensuring that the market mechanism in the supply of finance to SMEs is well functioning. The key market failure relates to asymmetric information between the financial institution and SME. Interventions should not be used to distort the competitive market mechanism by propping up inefficient businesses.
101. It should therefore be the role of the private sector and not the public sector to provide direct funding to SMEs. Where market failure has been identified, then there is strong case for Government to address any shortfalls in funding that could affect the competitiveness of the business community and the economy as a whole.
102. This should avoid competition with the private sector and work with the finance community to provide the most relevant solutions whilst increasing the joint effectiveness of public and private schemes in encouraging greater levels

of funding. They should use the expertise of private sector financial institutions and investors to make the investment or lending decision.

103. While the main aim of the DBW is to fill the funding gap, the ultimate method that should be used is by incentivising the participation and risk sharing of private sector and co-operating with the private sector to fill the gap rather than working on its own to supply the gap underserved by the private sector. The specific design of any funding scheme should align the private interests of the investor or lender with the objectives of the Government.
104. The real success of the DBW will be when the private sector displaces its operations and the market gap is filled.

#### ***Appropriate and affordable funding***

105. Businesses in Wales should have access to appropriate and affordable funding.
106. SMEs face different financial challenges depending on their size, sector and stage of growth. Given this, it can be argued that where there is a funding gap due to market failure, the public sector should provide specific interventions to support the provision, either directly or indirectly, of the most appropriate type of funding to each business.
107. There should be greater flexibility within publicly funded finance schemes to limit the cost of borrowing to SMEs and where possible, to utilise state aid regulations to support this.

#### ***Economic development as a priority***

108. The primary role of government-backed funding for SMEs is to drive forward economic development.
109. During the recession, publicly owned financial institutions across the World played a vital role in supporting SMEs and their financial requirements albeit with a dual focus on both a financial outcome and a wider social role. This has meant lower rates of return on capital but delivered greater stability and long-term support for SMEs.
110. The role of any publicly funded programme to support access to finance for SMEs should be to focus on economic policy goals as its first priority; but it should also support the individual goals of SMEs at the same time. In some cases, this may be best served by outsourcing the management of any related funding to an external organisation whose focus will be on developing the funded business more widely.

### ***Financial and business support offered together***

111. Business support should be offered alongside financial support to businesses rather than as separate elements. This joined-up approach is important for a well-functioning SME finance market since non-financial support is expected to bring about a stronger demand side that could stimulate the supply side.
112. Research has shown that various public organisations that are involved in supplying financial support to businesses also provide various types of business support to their clients. A recent evaluation of European financial instruments suggested that the provision of business advice is a key element of some financial intervention tools although this can depend on the stage of development of the SME.
113. There are advantages in having a joined up approach to business and financial support so that a company can evolve as it grows towards different services that it may not, for various reasons, be able access from the private sector at that stage in its lifecycle. The appropriate level of integration of these two services is discussed later.
114. There could also be benefits both in terms of reduction in costs and a stronger relationship with the beneficiary, leading to better access to information on the business that can lead to a reduction in risk when lending. More importantly, financial and business support needs to be available at different stages of the life cycle of the business.

### ***Customer focused approach***

115. Funding solutions should be customer-oriented and reflect the needs of SMEs at different stages of growth.
116. There are a plethora of different public funding schemes that are available to businesses in Wales including grant support, debt and equity funds, UK government export guarantees and credit insurance, and finance provided by the British Business Bank through intermediaries.
117. This is in addition to the different types of funding available from the private sector, such as loans, asset finance, and invoice discounting, as well as new types of alternative funding such as crowdsourcing.
118. This creates a confusing landscape for the average SME. Given this, there is a need for a single brand for in Wales that is responsible for the promotion and management of all public finance support schemes for SMEs in Wales.
119. In addition, government access to finance schemes should be targeted at where they have most impact. Providing support to businesses that can obtain finance from conventional sources (known as deadweight) ties up government

resources that could be used to support viable businesses that cannot obtain finance

### ***Stimulation of demand***

120. There should be stimulation of demand for business finance within the SME community.
121. It is appreciated that the provision of SME finance to Wales is not only a supply issue. There is a need to increase the awareness of the different types of funding that are available to SMEs, provide greater stimulation of opportunities for firms at all stages of the growth cycle and support the development of a stronger investment culture.
122. The financial ecosystem should also be strengthened through various mechanisms such as investor readiness programmes and the development of business angel groups.

### **3.3. Organisational and operational aims of the DBW**

123. Given the requirement for a Development Bank for Wales, the Welsh Government needs to determine what the organisation will do to meet its objectives.
124. The DBW will therefore be a Welsh public institution driven by public policy and market needs. Its mission will be to address the funding gap in the Welsh economy through being an effective and efficient public investor, supplying integrated finance and support whilst also stimulating demand, especially through non-financial services.
125. To achieve this, it will:
  - Provide loans, guarantees, equity and other financial instruments to support Welsh SMEs, whether in the profit or non-profit and social enterprise sector, as well as stimulating and encouraging new sources of finance
  - Act as a gateway for financial and business support for SMEs, some of which will be provided in-house and some through aligning closely public and private sector partners.
  - Stimulate the financial ecosystem through providing support for key stakeholders such as business angels as well as showcasing Welsh business to potential investors
  - Gather, collate and provide detailed information on the SME sector in Wales to enable an understanding of the dynamics of the Welsh economy and the funding gap in more detail so that appropriate interventions can be developed

- Be aligned with Welsh Government economic policy and establish close relationships with the sector panels, the enterprise zone boards and city regions.
- Ensure that, at a time of fiscal austerity, its access to finance schemes are cost effective.

## **4. WHAT IS A DEVELOPMENT BANK FOR WALES?**

126. This section will examine the arrangements for a new Development Bank for Wales in terms of governance, management and organisational structure, legal structure, financial issues, pricing, cost and resources, drawing on best practice globally.

### **4.1 The shareholder and governance**

127. Research shows that governments should develop and publicly communicate an ownership policy toward a PDB. The ownership policy includes the definition of the general terms and conditions that will apply to decisions regarding the amount, structure, terms and conditions, and the subsequent handling of the investment and the manner in which government will exercise its ownership. In a PDB whose main shareholder is the government (as in the case of the DBW), the shareholder's role is to appoint the board of directors, monitor the performance of the PDB, and to satisfy itself that an appropriate governance structure is in place.

128. Within PDBs, it is critical that there is an appropriate corporate governance framework that sets out the rules of engagement and the respective roles and responsibilities of the government shareholder, the board of directors, management and auditor. Across the world, PDBs can have either a one-board system (as is the current case for Finance Wales) or a two-board system (as in Finnvera and other European public banks). In the latter case, there is a supervisory board in addition to a management board and the supervisory board is to inform the government about the policy direction of the PDB and ensure there is mutual alignment. It is believed that a two-board structure would not be suitable within the UK context where it is less familiar and seen as both more cumbersome and adding cost, although its principles of accountability should be adhered to by a unitary board.

129. The board of directors is responsible for the governance of the institution, including setting its strategic plans and establishing performance indicators in line with the policy objectives defined by the shareholders and providing leadership toward their achievement, supervising management, and reporting to the shareholder. The chief executive (CEO), the senior management, and head of internal audit are appointed by board of directors. A board audit and risk committee should supervise external audit functions, review risk management and the system of internal control, and monitor the work of internal audit. This committee should be composed only of non-executive members and its chair should not be the chair of the main PDB board.

130. A transparent, structured process for nominating board members, including minimum fit-and-proper criteria, is important. A board governance committee would prepare an assessment of the skill requirements of the board members, recommend skill requirements for the selection of new directors and assess the capabilities of the current board members, and be responsible for approving the appointment of the CEO and other senior executives and for monitoring their performance and decisions on their remuneration.
131. For a SME-focused PDB such as the DBW, expertise in finance, innovation, technology and entrepreneurship, as well as governance, inclusion and regulation, are the necessary skills profile for members of the board that will help in decision-making. The shareholder representative should avoid nominating government officials as official board members if possible. As far as size is concerned, research indicates that the average number of members on the boards of PDBs is eight members.
132. The communication between the government and the PDB should be exclusively through the shareholder representative and the chairperson of the board of the PDB. The shareholder representative specifies the information required for evaluating the performance of the board of directors against pre-specified specific, quantitative and qualitative objectives. The shareholder representative is also responsible for coordinating the activities of the PDB and that of other economic development functions of the government. Also, given best practice amongst PDBs elsewhere, there should a clear delineation between non-executives and executives in terms of their responsibilities within the organisation, i.e. no executive member should be a member of the main board.
133. Board members should be appointed for a fixed term and the terms of individual members should be staggered. The purpose of this is to maintain the continuity of the institutional behaviour within the board. It also defends the independence of decision-making by the board since the shareholders are not able to remove board member whenever there is a disagreement (unless in extreme circumstances).
134. The levels of transparency and disclosure should be comparable with those of publicly listed companies, i.e. timely financial statements and annual reports are essential for making PDBs accountable for their actions. Conflicts of interest of the board members and senior management need to be publicly disclosed, including transactions with related parties. There should also be transparent remuneration policies set for executives and non-executives by an independent panel.
135. These best practice guidelines suggest that the governance arrangements of the new DBW should follow the following principles:

- The institution is a public body, fulfils a public mission and must be accountable to its public shareholder
- At the same time, it must also be able to pursue a long-term approach to its agreed strategic outcomes and should be held at arms-length from Welsh Government's day-to-day decision-making
- The board fulfils an important role as the buffer between the executive management and the Welsh Government and supervises the management. No executive member of the DBW should be a member of the board.
- The board must ensure that the DBW carries out its public mission while balancing the ability of management to execute this mission as they see fit.
- The governance of the DBW must comply with the relevant sections of the UK Corporate Governance Code
- Whilst having a continental model supervisory board and management board is unsuitable for this type of development bank, it is proposed that there is a formal meeting between the Welsh Government and the chairman of the board every six months to review progress and consistency with the policy aims of the government. The chair and the CEO will also be required to appear before the relevant NAFW committees annually.
- As part of this process, the board will release a detailed half-yearly report that will be published online for public consumption. This will contain details of performance against a focused set of qualitative goals and quantitative key performance indicators as agreed with the Welsh Government. It will also publish an annual report and be subject to regular external audits, the results of which will be made public.

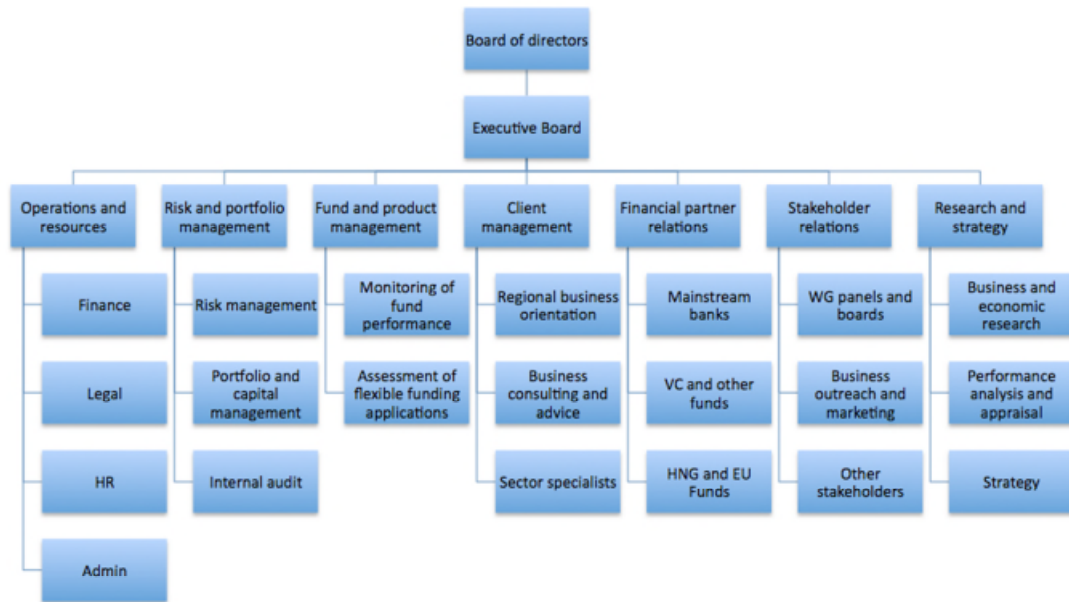
## **4.2 Management and organisational structure**

136. A hybrid model will be adopted for the bank where it may not have direct responsibility for running its own funds. This will mean that the management and organisational structure of a new DBW will be different to that currently being managed by Finance Wales.
137. As noted earlier, an executive team governed by a non-executive board would lead the DBW. The board of directors would be appointed by the Welsh Government in its capacity as sole shareholder and would ensure that the DBW delivered the mandate given by the Government and that the institution operated in accordance with best practices of governance.
138. The executive board will be led by the CEO who would be responsible for the executive leadership and management of the institution, taking charge of mandate delivery, strategy, financial performance and organisational health under the guidelines and delegated authorities set by the board. This role would be the public face of the DBW, particularly leading on relations with stakeholders (other than the government itself) and financial partners. A Chief



Operating Officer should also be appointed to counter-balance the CEO's expected strategic strengths with operational management capabilities.

Figure 2: Proposed organisational structure for the DBW.



139. It has been recommended that business support and Welsh Government grant support will remain organisationally separate to the DBW at this time. Given the importance of a close alignment of business and financial support, it is proposed that an operational liaison board is formed consisting of the directors of the DBW along with the heads of business support and grant funding within the Welsh Government. Meeting every month, this body will enable operational decisions regarding all three provisions of support to be better aligned. There will also be a need for operational resource to be allocated within each service – the DBW and each strand of Business Wales – to ensure the appropriate joint working and cross referrals happen on the ground.

140. Reporting into the executive board would be seven main operating teams namely operations and resources; risk and portfolio management; fund and product management; client management; financial partner relations; stakeholder relations; and research and strategy (Figure 2). Each team would have several functions as set out below, although it is likely that a number of the functions may be led by one senior executive. The teams are as follows:

- *Operations and resources*: This team would be headed by the COO and would handle internal organisational capabilities, such as budgeting and finance; external advisors (for example, the legal panel, or the pool of potential non-executive directors for client boards); human resource

management functions, IT and general institutional administration. At the outset, the COO would be one of the early appointments for the DBW and would be instrumental in ensuring that the Board and the CEO's planned structure was delivered efficiently on the ground. The COO would also lead in establishing appropriate operational protocols and procedures to ensure that the organisation was effective in delivering the strategy

- *Risk and portfolio management:* This would be an independent function that would lead on ensuring that all financial commitments were made in compliance with the DBW's risk framework. Where necessary, the client-facing teams would work with risk to obtain approval for and price individual extensions of credit. In parallel, the portfolio team would actively manage DBW's overall risk exposure. At the outset, the Welsh Government must be clear about the risk parameters for the DBW and ultimate degree of governmental support. For example, if the DBW would offer a guarantee under flexible funding, then the risk team would review it and suggest appropriate pricing.
- *Fund and product management:* This will be a different role to that currently being offered through Finance Wales, as it would be expected that the decisions for most funds on financing would be made largely outside the DBW. For example, the micro-loans fund would follow the example of the start-up loans fund by having delivery partners making the final decisions on loans up to £25,000. Similarly, the proposed equity funds would be contracted to various external firms although direct support would be provided in-house for the micro-equity funds. It would be expected that all flexible funding proposals would be subject to internal assessment before approval, although this would include the partner bank's due diligence results as it would be that bank, not the individual business, that would be applying to the DBW for financial support.
- *Client management:* One of the key roles of the DBW will be acting as the 'one-stop shop' for advice on funding for Welsh businesses; this would be reflected in its staffing. One capability greatly valued by businesses that seek investors is an understanding of the specific commercial context and an ability to provide useful linkages. This expertise is something that is expected by large corporations from their banking providers and there is no reason why we should not transplant this best practice to Wales. Therefore, the DBW client team would be composed of sector and regional specialists who could intelligently advise clients on the best route to seeking finance but also apply their specialist knowledge and contacts to the client's situation. To support Welsh Government policy, the advisers could mirror the same focused sectors as the sector panels. As a national institution, the regional teams would be embedded in the Welsh Government offices in Llandudno, Aberystwyth and Swansea but would spend most of their time visiting clients in every part of Wales. These advisers would work closely with the Business Wales general business,

growth and accelerated growth advisers or client managers.

- *Financial partner relations:* This team will build an on-going relationship with private finance providers that can be utilised by the Welsh Government for broader purposes, rather than the current infrequent calls for evidence and occasional meetings. It will aim to work as a complement to the banks and non-Wales based venture capital houses, rather than as competition. It should institute a referral and risk-sharing pipeline between Wales and mainstream finance and, where applicable, support those Welsh businesses seeking specialist investment where it would be inappropriate for the DBW to provide it. In addition, this team would lead on building relationships with the UK business support organisations such as the British Business Bank, UK Export Finance and the Green Investment Bank. Currently, there is no consistent message about investing in Wales nor are Welsh companies regularly helped to connect with outside venture finance or growth finance providers. London finance houses see many opportunities from other parts of the UK and Europe, and this function will enable Wales to promote the offering of its indigenous companies.
- *Marketing and stakeholder relations:* The team would handle external relations with the media and other selected stakeholders to ensure that the DBW's profile supported its mandate and aims so that people understand the institution's role and context. This team would be responsible for developing and implementing a more proactive marketing strategy for the DBW as discussed earlier that would help promote greater entrepreneurship and business development in Wales. It would also be responsible for internal marketing within the Welsh Government and would focus on improving alignment between the DBW and Welsh Government's wider policy aims. In this respect, it would work closely with the sector panels, regional boards, regeneration programmes, and universities.
- *Research and strategy:* This team will carry out strategy investigations, research and analysis for the board and CEO. It will also undertake or commission research into SME financing requirements and the business environment in order that the DBW can be responsive to market demands. A final function would be to undertake on-going measurement of the DBW's performance against its aims, as well as appraising the effectiveness of the DBW's activities in supporting business and economic growth.

### **4.3 Legal and regulation issues**

141. There are three main regulatory and legal hurdles for the DBW to clear before it can call itself a bank in regulatory and legal terms.

142. The primary regulatory issue is whether an institution carrying on 'public developing banking' activities would need to be regulated in the UK. Given the precedent of the British Business Bank, which was recently authorised by the Financial Conduct Authority (FCA), and subsidiaries of the Green Investment Bank and Finance Wales, some of the activities of a Development Bank, which would include making and managing investments, could fall under the offices of the FCA.
143. A second hurdle could relate to EU State Aid – again the precedent of the British Business Bank is helpful – as it received clearance in October 2014 and having received a positive response on its application, it has offered to assist with the process.
144. The final hurdle relates to whether Companies House would allow an institution to call itself a Bank if it was not regulated as a bank, yet was carrying out financial business. The FCA would therefore need to provide permission for the DBW to call itself a bank.

#### **4.4. Financial structure.**

145. As discussed earlier, PDBs can be funded in several ways and given its initial remit, it is expected that at this stage the DBW will not immediately look to borrow from other financial institutions, raise money in the capital markets or take savings or deposits from the public. However, these strategies could be adopted in future, depending upon any potential changes in the borrowing powers of the Welsh Government and a greater appetite for SME finance than public funding can fulfil. Hence for the first five years of its existence the DBW will be dependent on the Welsh Government (including EU funds) for its funding.
146. The aim of the DBW would be to be self-financing within its first five years, if not sooner. This will need a careful balance between ensuring the cost of borrowing for SMEs is minimised to encourage greater development with covering the operational costs of the organisation.
147. It was a key recommendation of the NAFW Committee that, when designing future funds, there needs to be sufficient flexibility to adjust interest rates and to take advantage of EU State Aid exemptions. For the DBW, the cost of potentially reducing interest rates should then be planned with Welsh Government to ensure that sufficient financial support is available. However, a detailed paper presented to the T&F Group has shown that both the default rates and fund management charges for Finance Wales are high. Reducing operational cost by streamlining the delivery of financial products and establishing more cost-efficient organisational structure could also reduce the interest rate faced by borrowers.

148. Given that in the case of Finance Wales, half of their loans are classed as high risk, then rectifying this and a potential higher default rate, along with the cost of funding and operations, is one of the key requirements of making the DBW sustainable as well as being able to offer a lower cost of borrowing to less risky firms as part of a more balanced portfolio.
149. As in the example of Finnvera, the new Development Bank may wish to consider whether (or not) it provides finance to high-risk businesses through its main funds. If not, then this would enable the default rate to be substantially reduced that will impact positively on the selection and subsequent management of clients. The risk is that there may be an expectation that the DBW will fund any business that applies and that expectation will need to be managed when launched.
150. As a publicly owned body, the DBW will be a responsible lender above all and its overriding objective should be to lend prudently, with low impairments, within a lending book that is grown incrementally. As a PDB could be working at the upper end of the risk spectrum, the higher quality of risk management and due diligence are even fundamentally important.

#### **4.5 Costs of a Public Development Bank**

151. The development of a hybrid model where the majority of the funds are outsourced presents the opportunity for the Welsh Government to develop a more efficient and cost-effective organisation for it to support. This will ensure less cross-subsidy across funds (including between debt and equity) and therefore a clear delineation between central costs and fund management costs which are currently blurred within Finance Wales.
152. The final costs of the DBW will be dependent on the organisational strategy adopted within the business plan for the DBW. However, given that staff costs and professional fees account for 75 per cent of the current administrative costs of Finance Wales, there may be scope for reallocation or reduction of these costs, potentially for reducing the cost of borrowing to SMEs. Certainly, greater efficiencies may arise from working more closely with external partners as this could reduce the cost of fund management, internal due diligence and professional fees to intermediaries.
153. The utilisation of professional experience and knowledge from the private sector would also increase the allocation efficiency of public funding, especially as the enhancement of the professionalism of the public intervention is one of the criteria recommended by BIS in designing a programme to promote SMEs access to finance.

## **4.6 Performance measurement**

154. The emphasis for any PDB must be on the output, i.e. what has been achieved as a result of the investment and not on how much funding has been invested. This is a step-change from the current approach adopted by Finance Wales where the focus on performance is measured mainly by the number of investments made and return on investment, which is largely a result of the fund management function of the organisation.
  
155. A research function within the DBW will be critical in ensuring that its activities and impact are measured on a regular basis. Not only will this allow informed decisions to be made by the DBW in response to market changes but will enable the Welsh Government to justify the interventions made on its behalf. In this respect, the DBW will draw on the expertise of the British Business Bank which has established a detailed monitoring and evaluation process to understand what the cumulative effect of its activities has been on the market, who have been the main beneficiaries of these activities and what, if any, have been the unintended consequences and why. Furthermore, given the promotional role of the development bank, other measurement such as indicators reflecting incremental effect, the demonstration effect, the achievement of transferring skills and the enhancement of social awareness should be included. There should also be evaluation on the deadweight effect and substitution effect as mentioned above.

## 5. WHAT WILL A DEVELOPMENT BANK DO?

156. Research has shown that sources of financing for SMEs tend to evolve according to the nature of the firm and over the life cycle of the firm. Different problems arise as firms approach a new phase and deals with different kinds of investors. It is important to have a range of options for SMEs as they progress through their business life cycle.
157. PDBs with a mission to foster the SME finance market typically show a strong propensity to provide a universal range of financial products in order to better suit the particular requirements of individual projects. Therefore, besides traditional commercial loans and guarantees to support SMEs and innovative firms, they also support business angels and provide access (directly or indirectly) to venture capital funds.
158. Within a PDB, a mixed range of financial products would be helpful in mitigating the mismatch between the optimal method of external finance demand by firms and the available public intervention required. Therefore, the provision of different types of finance to be offered has to take into account the possible economic outcomes to be achieved.
159. Cost-benefit analysis of the extent to which the desired outcome could be effectively delivered must also be considered and the provision of the different types of financial products needs to be carefully designed and be prioritised. This is crucially important for a regional PDB like the DBW given the limited resources available and the fundamental significance of maximising the outcomes from public intervention.
160. Therefore, the DBW will undertake the following.
  - Provide or commission a full range of debt and equity financing products. This will also include addressing structural failure within the finance and support markets in Wales, such as stimulating the business angels market; encouraging and supporting the use of alternative finance; working with the banks to develop better referral systems between the public and private sector; and encouraging public finance providers to seek investment opportunities in Wales and grow the provision of social finance
  - Ensure that financial support through the DBW is fully aligned with Welsh Government business support functions
  - Develop a strategic research and development function that will enable the DBW and the Welsh Government to understand the SME sector in Wales and to deliver the products and services required

- Have an active outreach programme that will build relationships with key stakeholders in the business and finance community, including the provision of financial training and support for businesses and intermediaries.
- Stimulating business demand in the marketplace by acting as a catalyst in promoting new business development and growth in Wales as well as supporting businesses through acting as a signpost to different types of funding mechanisms.
- Ensure there is positive engagement with key stakeholders through engaging positively with politicians, civil society, the media and others as well as ensuring there is growing Welsh visibility with external financial providers and public bodies.

## **5.1 New financial products**

161. It is the considered view of the T&F Group that one of the key principles to be adopted in considering the role of the DBW is that it is not the role of the public sector to displace the private sector but to address a market failure in the provision of finance to SMEs. This is why a hybrid model has been adopted for the new bank.
162. Within such a model, consideration must be given as to whether a new DBW continues with the Finance Wales approach of developing its own funds to meet the general needs of SMEs (and effectively competing with other private sector providers) or whether its aim is to address the specific requirements of different target groups not adequately served by current providers such as the high street banks by utilising the most cost-effective and appropriate vehicle for the delivery and the professional knowledge of the private sector.
163. As noted earlier, PDBs need to focus on a number of targeted market segments to be effective. Research undertaken during the review suggest that there are currently seven types of businesses that are struggling to attract funding from traditional lenders and that the public sector could be supporting. These are:
- Start-up firms
  - Microbusinesses
  - Low to average risk SMEs that have been refused credit due to affordability, collateral or sectoral issues
  - High risk SMEs with no collateral and low credit rating
  - High growth firms
  - Exporting firms
  - Social enterprise



164. With the exception of high risk firms and the microloans fund, the current funds operated by Finance Wales do not fully or adequately address the needs of these different target groups in their current structure and that a new approach is needed which specifically addresses the requirements of each category in a different way.

### ***Start-up firms***

165. The first Access to Finance review recognised that there was no specific programme targeted towards lending to start-ups in Wales. It was recommended that the UK Government's start-up loans programme should be adopted in Wales and this was introduced in October 2013. This initiative provides low cost loans to start-ups of up to £25,000 alongside mentoring support.
166. The latest data shows that 639 loans have been drawn to date through the start-up loans programme as compared to 76 start-ups supported by Finance Wales through its JEREMIE Fund since June 2009. Whilst it is offered as part the Business Wales provision, the Start Up Loans Company manages the programme itself and contracts directly with four delivery partners in Wales. In this respect, there is no significant management role for the Welsh Government in this process apart from promoting the scheme and monitoring its outputs.
167. At this stage, there is no reason why this arrangement should change. But it should be kept under review going forward, especially as the public support of start-ups remains a devolved issue and considerable funding is targeted towards business support for this segment. At the very least, there needs to be an agreement with the British Business Bank (via its contract with the Start-Up Loans Company) for reporting mechanisms to be in place over the progress of the programme in Wales and there should be a requirement for direct access to information on the key performance indicators for the scheme to be shared with the DBW and the Welsh Government. The DBW may also wish to consider if the scope of the programme changes (such as lower default rates) whether it may wish to use its own funding to ensure that it continues to service the needs of start-ups in Wales.

### ***Microbusinesses***

168. Currently there are 219,000 microbusinesses (having between 0-9 employees) in Wales and these make up the vast majority of businesses in the economy, accounting for 34 per cent of all employment in 2014. More importantly, this group of firms had the largest growth in employment in Wales (up 26 per cent) as compared to 15 per cent for all firms during the period 2003-2014. Microbusinesses were also responsible for 53 per cent of the increase in employment during this period and for 85 per cent of the increase in employment between 2008 and 2013 when the economy went through, and recovered from, one of the worst global recessions in living memory.

169. As shown earlier, there remains a gap in the provision of finance to newer and smaller firms in Wales despite the growing importance of this sector for employment in Wales. This demonstrates a clear market failure that the Welsh Government could, if it so wished, directly address.
170. This market failure was recognised in the two main recommendations of the 2012 Welsh Government's Micro-Business Task and Finish Group Report. In terms of access to finance, the Welsh Government should facilitate accessible finance of between £1000 and £20,000 that is simple. It should also reflect the level of investment required and support micro-businesses to access appropriate finance options. This is why the microloans fund was developed in 2012 and was eventually taken on by Finance Wales as one of their products.
171. Given the high number of microbusinesses in Wales, there has been concern as to why the scale of the microloan fund (£5 million) was comparatively small, given the scale of the potential demand. This approach seems to have been confirmed by a recent Regeneris report for Finance Wales, which implied that there was only a case for provision of debt to microbusinesses in Wales within a future fund in the range of £0.8 million-£1 million per annum (£4 million-£5 million in total over five years). Unfortunately, this was based solely on the experience to date of the JEREMIE Fund in supplying funding to microbusinesses and not on any examination of the overall demand in the Welsh marketplace.
172. The introduction of a new fund targeted towards new and small businesses has shown that it has been successful in getting funding out to the microbusiness sector in Wales. Since Finance Wales' Microloans Fund made its first investment in October 2012, £2.5 million has been invested in 105 businesses, attracting a further £2.7 million of private sector funding. This demonstrates the demand in the marketplace from microbusinesses that was previously not being served by the public sector in Wales despite the failure by existing private financial institutions to serve this market.
173. The introduction of a larger fund that is specifically aimed at serving the needs of microbusinesses in Wales reflects one of the key principles of the DBW namely that "the primary role of government-backed funding for SMEs is to drive forward economic development". In focusing on this type of SME finance, it is clear that there could be a considerable economic impact in terms of new jobs across the whole of Wales.
174. Whilst there is clear evidence of a need for funding provision for microbusinesses in Wales, the challenge for any financial institution is in the delivery of a microloans product to a large number of businesses. Given this, the T&F Group is of the opinion that whilst the DBW could deliver this funding directly to businesses (as is the case with the Microloans Fund managed by

Finance Wales) it would be more effective for the DBW to work with partners across Wales to deliver this programme.

175. This process is already being utilised effectively by the Start Up Loans Company. It has a national distribution network of delivery partners who operate across the UK working with individuals to develop their business ideas into a feasible business plan in order to increase their chances of successfully receiving a loan.
176. In Wales, there are three recent examples where the Business Wales business support network has undertaken a similar role:
  - The Start Up providers within the Business Wales programme are also now Delivery Partners for the Start Up loan programme in Wales – the UK Government backed fixed interest, unsecured personal loan.
  - The Business Wales delivery consortium administered the SME Capital Grant fund in 2013/14, resulting in a Welsh Government investment of £1.8 million within three months, match funded by the successful SME applicants, and delivering 264 jobs (264 created with a further 195.5 safeguarded).
  - The Business Wales delivery consortium is currently delivering the Welsh Government's SME Capital grant scheme in Pembrokeshire in response to the Murco closure.
177. The T&F Group concluded that any future microloans programme managed by the DBW should not be directly delivered but should adopt the mechanism currently utilised by the Start Up loan programme, where partners in the Business Wales support network are responsible for working with clients to develop their funding proposals with the role of the DBW being to give final approval on funding. This would ensure that micro-businesses get the maximum support in developing their ideas whilst minimising any administrative delays that would normally be associated with direct delivery.
178. As the Business Wales partners are familiar with the needs of their clients, they will be able to overcome the information asymmetry challenge that many banks now face when dealing with micro-businesses. Such a scheme would require consideration of the requirements of the Financial Conduct Authority (FCA) for the companies involved in delivery and their financial expertise. It would also need clear guidance on the objectives of any such scheme and the results required, as well as a level of volume to make it worthwhile for the deliverer.
179. The DBW through its outreach function, would also raise awareness of the scheme among private intermediaries, such as accountants, encouraging them to work with microbusiness clients to deliver funding proposals across Wales, especially as surveys have shown that SMEs perceive them as the most trusted source of advice, followed by friends, family or business associates and Chamber of Commerce or business representative organisation.

180. Another potential delivery channel that could be considered by the DBW is to work in a partnership with credit unions in Wales, given those institutions would have stronger vested interest in the development of local community, compared to local branches of national banks. In fact, nurturing institutions that have stronger vested interest in the local economy should be one of components of the promoting role of the DBW. While it would be argued that the selection of partners in the private sector should not carry any discrimination propensity, the analysis on the cause of higher credit constraints faced by SMEs in Wales suggests the inefficiency of local branches of national banks and therefore the importance of local solutions in supplying SMEs lending.
181. Evidence suggests that there may be considerable demand in the marketplace for a product that is focused on the financial needs of microbusinesses. For example, data extrapolated from the SME Monitor shows that of those that had applied for a bank loan, only 39 per cent of microbusinesses were offered what they wanted with 48 per cent being declined by banks.
182. That suggests a funding gap for microbusinesses in Wales that had been refused bank funding of around £40 million per annum. Of these, 7 per cent of those initially declined for a loan had managed to secure a loan with either the original bank or, more often, a new supplier. A further 21 per cent had secured alternative funding, with friends/family and/or personal borrowing most likely to be mentioned. 73 per cent of those initially declined did not have a facility at all; this is equivalent to a gap in funding for microbusinesses in Wales of around £29 million annually.
183. In addition to those that have been refused access to funding from banks, the SME Monitor shows that the demand for debt funding from “would be seekers” (those SMEs that had not had a borrowing event and said that something had stopped them applying for loan/overdraft funding in the previous 12 months) amongst microbusinesses could be as much as £127 million. The demand from microbusinesses that classed themselves as “future would-be seekers” (those that felt that there were barriers that would stop them applying to borrow more) in the next three months was estimated to be £435 million.
184. Therefore, this would a major programme of funding and support for the backbone of the Welsh economy. If a fund of £50 million were created, this could support around 3,000-3,500 microbusinesses across the whole of Wales with the expectation that each firm would create at least one job each.

#### ***Low to average risk SMEs***

185. As the Access to Finance reports and other research have pointed out, banks have tightened their lending to SMEs in the last five years and since the financial crisis of 2008, have reduced lending to UK SMEs by nearly a quarter.

Yet despite the recent growth in alternative sources of funding and the creation of public sector fund managers such as Finance Wales, bank lending remains the most important component of debt financing for the SME sector, with UK SMEs still relying on banks for 80 per cent of all of their credit.

186. In the first Access to Finance report, security against the loan (collateral) and affordability of repayment, rather than the cost of borrowing, was cited in the interviews with banks, intermediaries and small businesses as being the main obstacles to accessing bank finance. Whilst the UK Government has focused particularly on supplying more money to financial intermediaries via the British Business Bank, this has not specifically addressed these obstacles.
187. The DBW would work alongside the banks to address the gap between the funding required by the business and the amount that a financial institution is able to lend under its credit criteria, thus enabling access to external financial resources without diminishing the financial responsibilities of the borrower. It would collaborate with financial institutions to issue guarantees or subordinated loans on the basis of a sound and comprehensive analysis of quantitative and qualitative risks. It would also support invoice financing as a mechanism by which businesses can gain access to funding.
188. In terms of the DBW, this principle of flexible funding would be a focus away from public funds being perceived as a 'lender of last resort' to filling the market gap where it exists by working alongside other finance providers to close those deals that may otherwise be lost to the Welsh economy.
189. The other key advantage is that it would be expected that the due diligence on any guarantee, subordinated loan or invoice discounting support would be undertaken by the bank under full disclosure and not the DBW. Given the high level of administrative cost currently associated with the supply of loans to SMEs through Finance Wales, this would streamline the decision-making process and reduce costs for both the customer and the public purse.
190. If managed properly, this innovative approach to gap funding could generate additional funding for businesses in Wales to enable them to grow. A similar exercise was undertaken with the UK Government's Regional Growth Fund (RGF) that provided grant funding directly to various banks to close this funding gap. For example, data from RBS shows that £300 million of investment was leveraged by using £70 million of RGF grants to close the gap between what the bank could offer and the business required. This is estimated to have created 2,500 new jobs and safeguarded a further 9,400.
191. This concept of flexible funding is something that is currently missing within the Welsh financial system, especially where the public sector works directly with the banks to address a market failure due to issues such as reduced affordability or lack of collateral.

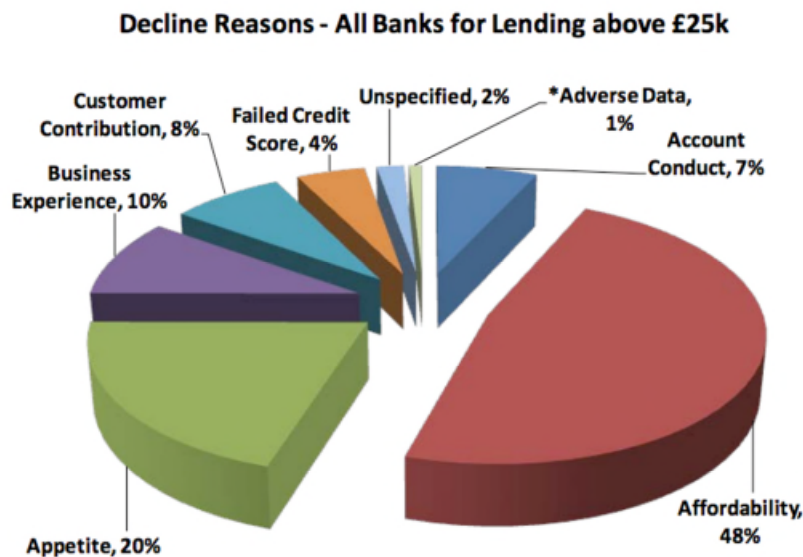
192. As a result, a broader view of flexible funding can be introduced where the DBW works with the banks on individual cases to ensure that any obstacles to supporting businesses can be overcome. This would be expected to be targeted at larger small firms and medium-sized businesses i.e. those looking for funding over £25,000. In this respect, we see three challenges that such a flexible funding approach must address in delivering funding to low to average risk SMEs namely affordability, collateral and invoice financing.

Affordability as barrier to funding

193. From discussions with the banks, it is clear that more stringent rules regarding credit availability have reduced the terms of loans and the affordability to many businesses. This supported from evidence in the Large RBS review that noted that *“RBS shortened the commitment period for term loans offered to customers. For example, the average contractual term for Commercial Banking loans was approximately 9 years for accounts opened in 2008, which shortened to approximately 5 years in 2009, and has continued at that level since.”*

194. In addition, the latest Banking Taskforce Appeals Process Review (2014) has shown that for bank lending above £25,000, affordability (48 per cent) is the key reason for decline followed by a lack of appetite (20 per cent) to lend to this sector due to either the type of business or sector or another internal policy constraint (Figure 3).

Figure 3. Decline reasons by banks for lending above £25,000



195. In terms of how a public authority can make loans more affordable to businesses, the most relevant example comes from Ireland where the Strategic Banking Corporation of Ireland (SBCI) has been established to intervene to support SME lending. Its goal is to facilitate the delivery of lower cost,

innovative and accessible funding to Irish SMEs through a suite of flexible products offered by a wider range of financial institutions than is currently available in the Irish market. These will initially include long-term working capital and capital investment finance through a number of lending partners, including both bank and non-bank lenders. What has been of interest to the T&F Group is the development of specific products that will include longer maturities and payment flexibility for SMEs.

196. In the case of the SBCI Investment example below, the bank would still offer a three-year loan to the business but this would be supplemented by a further three-year loan from the DBW on the same terms so to improve the affordability of the business whilst ensuring that the bank is still involved in providing the funding to the SME and that the risk is not just passed onto government.

**SBCI INVESTMENT EXAMPLE**

*(Source: [www.finance.gov.ie](http://www.finance.gov.ie))*

*Background:* A group of entrepreneurs have come together to launch a joint venture that would manufacture a product new to Ireland. Their plan is to build a new factory in Cork. They have a successful track record in their individual areas of business. Their proposed business venture will add value to agricultural sector waste products that are normally a cost for farmers and food manufacturers. Ireland produces more of the raw material needed due to its climatic competitive advantage. When the business is up and running, it will employ twelve people. The entrepreneurs have a well thought out business plan and have made contacts with established buyers in both domestic and international markets. As this is a new idea and has not been developed in Ireland before, a new factory has to be built. The machinery will cost €2m and will have a life span of 15 years. The project has a payback period of six years.

*Prevailing Loan Conditions* - At the moment, their bank will only offer a three-year loan. This puts greater demands on the project and reduces the enterprise's chances of success as there are steep loan repayments to be made monthly over 36 months. Even though the project is profitable, the repayment schedule increases the risk of failure.

*Strategic Banking Corporation of Ireland Loan:* A possible SBCI loan facility could provide a six-year loan so that the repayment cash outflow each month is a lot less than their bank's current three-year repayment. This reduces the cashflow risk to the business and increases its probability of success as a cashflow crunch for a profitable can cause it to cease trading.

197. In terms of the DBW, it may be more difficult to introduce specific products within the banking system given the way that banks are organised in the UK, especially with the lack of geographical boundaries between England and Wales in terms of corporate finance divisions. In addition, it would seem that

the public funding is merely replacing private funding where there are affordability issues for SMEs rather than ensuring that the funding is there to close the gap between what the bank can offer and what the business requires.

#### Collateral as a barrier to funding

198. The economic downturn has led to firms' assets reducing in value and consequently limiting the amount they can borrow from the bank to grow the business, a situation that has continued today and, according to discussions with banks, is unlikely to change, especially with property prices stagnant in regions such as Wales.
199. Many SMEs who borrowed against properties valued at the peak of the market have found themselves with loans that they are struggling to refinance as the value of the property has decreased so much. As a result, banks are no longer prepared to finance at high loan to value (LTV) ratios thus reducing the amount that the SME can borrow against a secured asset.
200. One of the key approaches in ensuring that businesses gain access to funding in a situation where the value of collateral is declining is through public guarantees that form part of the European financial services landscape for SMEs. For example, an analysis of European Commission programmes showed that whilst 57 per cent of the value of financial instruments to support enterprises was in the form of loans, 36 per cent were guarantees.
201. While banks have been and indeed continue to be the principal source of external capital for SMEs, publicly funded guarantee schemes have a complementary role to play by making guarantees available to compensate for SMEs' insufficient collateral.
202. In the UK, the only major guarantee scheme is the Enterprise Finance Guarantee Scheme (EFG), the successor to the Small Firms Guarantee Scheme originally established in 1981 by the UK Government. This is a loan guarantee scheme that enables banks and other lenders to lend to small businesses that lack security or a proven track record. It provides lenders with a 75 per cent guarantee on each individual loan issued under the scheme, subject to a 20 per cent limit on total claims arising from a lender's portfolio. This shares the risk of the loan defaulting between the business (that pays a premium), the government and the lender. The scheme is relatively inflexible as it does not address the specific needs of individual businesses but merely provides a guarantee to the lender on each loan.
203. Currently, EFG accounts for between 1-2 per cent of all loans and yet the SME Monitor shows that 7 per cent of loan applicants are offered less than they wanted by the banks. These types of business are likely to be older firms (having been in business for more than 15 years), have an average risk rating, be employers (i.e. not self employed) and applying for loans in excess of



£25,000. This means that whilst growing businesses may require capital for growth initiatives, they may lack the necessary resources or assets to secure the requisite finance and there may be challenges in demonstrating the viability of their projected growth to private sector funders.

204. A mechanism to de-risk private sector investment, such as a flexible guarantee scheme or a subordinated loan providing variable percentages of support, could unlock the true potential of growth businesses in Wales. This could be particularly attractive as a more mature business reviews its finance package as part of a drive to improve operational efficiencies.
205. Some solutions will often require additional security that even well established businesses would lack. In this respect, there is a role for the DBW to play in supporting private sector leverage by means of the guarantee mechanism to release such funding.
206. For example, if there was a Welsh SME that wanted to borrow £500,000 to develop a project to grow its business and its bank would only, based on the security it could offer only provide £300,000, then the options for that business would be to (a) turn down the offer and abandon the project (b) accept the lower amount but restrict its growth plans for the future or (c) look for other funders which might take more time and cost more. Through flexible funding, the DBW could offer either a guarantee for the remaining £200,000 or have its own cash facility to provide a subordinated loan at the same cost of borrowing. This would again ensure that the bank is taking the majority of the risk and providing most of the funding.
207. As with the EFG, the DBW would only sanction facilities once the DBW has confirmed the applicant's plans are viable through the appropriate due diligence, that they would wish to lend to the applicant and that all the applicant's available collateral has been exhausted. This guarantee could be extended beyond a loan into other areas such as overdrafts or invoice finance, as well as new forms of finance such as asset finance, performance bonds and various international instruments.
208. Working with private sector to fill the funding gap is a key priority of the DBW. In this respect, it would be looking to provide the finance, in the form of a guarantee, which enable the banks to over come collateral or affordability issues and lend to Welsh SMEs. Assuming that the average guarantee is 30 per cent of funding request, this would mean that a fund of £50 million would generate an additional private sector leverage (PSL) of around £120m into the Welsh economy (or a ratio of 2.4:1).

#### Invoice financing

209. As the Access to Finance review demonstrated, the increase in market-demand for working capital finance in the SME sector has created an opportunity for

the invoice finance (IF) providers, particularly independent firms, to grow even more quickly, satisfy this demand and be capable of scale and significant efficiencies. Under the right circumstances, IF can often release funding into the business immediately and at a cost that is considerably lower than many bank overdrafts or loans.

210. Despite these advantages and the continued growth of the invoice finance industry, only 43,000 SMEs out of a total of nearly 5 million are currently utilising invoice finance. It is estimated that there could be a suitable, factorable and untapped market of between 400,000-600,000 UK SMEs (or, proportionately, 1,600 to 2,400 in Wales) indicating that the overall market has significant growth potential.
211. Similarly, asset-based finance can fund the purchase of much-needed new assets to assist growth (machinery, equipment, commercial vehicles, IT, telecoms, shop fittings, office furniture, etc.) and in some circumstances can be used to release funding for working capital against equity in already-owned assets.
212. Whilst both invoice financing and asset-based funding is available from both the banks and independent providers, there is a general lack of awareness by SMEs of the advantages of utilising this source of funding.
213. As part of its wider role within the Welsh finance community, the DBW should look to raise market awareness of this type of financing that could, if adopted properly, have an impact on the way some businesses in Wales can gain access to capital to grow their business. In this respect, the role of the DBW could be to act as a signpost for a panel of preferred independent funders.
214. In terms of any direct financial support, the DBW should only act where there is evidence of market failure. Whilst independent IF providers have a much greater acceptance rates than the bank providers, provide a more flexible facility and a higher level of service, they are restricted in the funding lines they can obtain from their own funders (generally the banks) due to their capital constraints and the cost of borrowing. This restricts the size of their 'lend' to a maximum of £500,000 whilst bank providers are primarily interested in the larger 'corporate' deals where they are providing over £1 million. Therefore, there is a funding gap in the £500,000 - £1 million segment that is best served by the independents but who are generally unable to satisfy for the reasons given above.
215. There are a large number of Welsh SMEs that fall within that range but are not adequately catered for. If additional funding lines were available, then a huge impact could be made to these businesses and the jobs they wish to create. One of the major advantages of invoice finance is that the cash lent 'turns' on average every 57 days. In other words, the amount lent is repaid by collections from the debtors in this timescale and is then lent again. With such a 57-day

debt turnaround, the same amount of funding can be lent over six times annually. This keeps the borrowing requirements of the invoice finance provider to quite low levels. For example, an invoice finance provider lending on average £500,000 to one client can in fact lend this six times annually even though the provider only needs to borrow £500,000 once.

216. A funding line of £25 million would support a provider's lending to 50 Welsh SMEs (all borrowing £500,000 on average), but who would actually receive cash totalling £3 million (£500,000 x 6) during the year. That would support any SME with a turnover of up to £6 million and allow them to grow much more quickly.

### ***High risk firms***

217. One of the key market failures regards those firms that currently fall within the highest risk category i.e. have little or no collateral and a low or zero credit rating. As a result, traditional lenders, such as high street banks, will not be able to provide funding for such businesses. Even the instruments described above to support collateral and affordability issues for low to average risk businesses are unlikely to be sufficient to overcome the concerns of the high street banks.
218. With a policy of businesses having to have been turned down by high street banks before they can approach Finance Wales, it is not surprising that nearly half of Finance Wales' loans are to firms in this category.
219. There is evidence that whilst low-to-average risk businesses within Finance Wales' portfolio are paying higher interest rates than would be expected, high-risk businesses are paying only 1 per cent more than the suggested reference rate. Whilst this could be described as an economic development role for the organisation, best practice on PDBs has suggested that such firms should not be supported by public funding,
220. The T&F Group has also raised questions as to whether these types of businesses should be supported by a publicly owned bank, especially as similar institutions, such as Finnvera, have a clear policy of not providing finance to high-risk businesses. As such, there are two options that could be implemented in supporting this group of companies.
221. The first is that a specific high-risk fund could be established by the DBW to service the financial needs of these businesses. It is unlikely that this would be a debt fund as equity is best suited to this category of business. In addition, there would be additional business support for such firms as part of the arrangement.
222. The second, and preferred option is that the DBW does not itself invest in this category of firms but facilitates introductions to alternative lenders as part of

its outreach and information role. In this respect, it would work closely with National Association of Commercial Finance Brokers (NACFB) and its advisers to ensure that firms that are classed as high risk are provided with access to other private funders who are better suited to supporting them.

223. The relationship with alternative sources of funding would form part of the offering to those firms that would find it difficult to gain support from mainstream providers. According to the latest 2014 report from NESTA on crowdfunding, there was around £1.1 billion lent to SMEs through various platforms in 2014. Proportionately, £44 million should have been available to Welsh businesses although the actual amount is probably lower given the small number of deals that have been completed in the equity crowdfunding space in Wales.
224. It would not be expected that the DBW would be directly involved in the supply of all types of alternative sources of funding, such as asset-based finance or crowdfunding, though all have a role to play in the supply of finance to SMEs (although it could help to close a market gap in the supply of funding to SMEs, as the example of the role of invoice finance discussed earlier has shown).
225. Various recommendations were made during the first Access to Finance review including that the Welsh Government should take the lead in supporting alternative sources of funding such as peer-to-peer lending and crowdfunding, either through partnership or direct funding. It could also raise awareness of both types of funding through its various business support programmes.
226. Whilst there is already public sector support for crowdfunding through the British Business Bank, this may not be a market intervention that Welsh Government wishes to pursue at this stage to support high-risk firms. However, the DBW should act as an advocate and signpost for SMEs seeking other types of funding for their businesses that supports the principle that businesses in Wales should have the opportunity to discuss options for appropriate funding.

### ***High growth firms***

227. Whilst high growth firms make up only 6 per cent of all those employing more than 10 people, they account for more than 50 per cent of net new jobs created. Again, in focusing on providing support to these businesses, the DBW is not only fulfilling the key principle of addressing market failure (as research as shown that high growth firms operating in innovative sectors face difficulties in attracting early stage funding) but, more importantly, will be again addressing the principle that government-backed funding for SMEs is to drive forward economic development.
228. Various studies have shown that in terms of developing high growth firms, informal investment (business angels) and formal investment (venture capital)

are the two dominant methods of ensuring these businesses grow quickly with the right type of finance and, more relevantly, the type of support required. The T&F Group is of the strong opinion that this type of finance and support is critical in supporting the growth of high potential firms that can have a major impact on the Welsh economy. The DBW will need to work closely with the WG's Accelerated Growth Programme provider (currently under tender) to ensure that growth firms are identified early and receive the targeted support required.

### Business angels

229. Wales is currently underperforming in attracting informal investment from business angels, especially as compared to other regions such as Scotland where a strong angel network support system has been established. This is despite research showing that by far the most significant source of equity capital for high growth potential businesses are individual informal investors (or business angels).
230. Business angels provide support for the formal venture capital sector by seeking out new entrepreneurs and nurturing them up to be investment-ready, thereby raising the number of start-ups and increasing the deal flow for venture capital companies. In this respect, business angels are widely recognised to play a key role in the first round of equity capital of 'the funding escalator' prior to entry by venture capital for a small proportion of companies. The vast majority of successful high growth potential businesses taking equity finance do not receive venture capital funding, even in the most developed capital markets such as the USA.
231. There are substantial barriers to entry and disincentives to more high net worth individuals becoming business angels. These include the necessity to learn new skills, the higher risk of business failure and the illiquidity of the asset class.
232. During the last few years, the UK has benefited from a number of governmental policies that have attempted to provide incentives to overcome these issues at a national level, principally through the provision of substantial tax incentive schemes.
233. It is evident that those regions that have taken additional measures to invest in the development of the 'supply-side' of business angel finance are able to achieve far higher levels per head of population than those that do not. Regions that encourage the development of multiple angel groups, syndicates and networks and thus providing a range of choice to entrepreneurs and potential investors to engage, are able to mobilise substantially greater per head volumes of capital than those who have a single network.

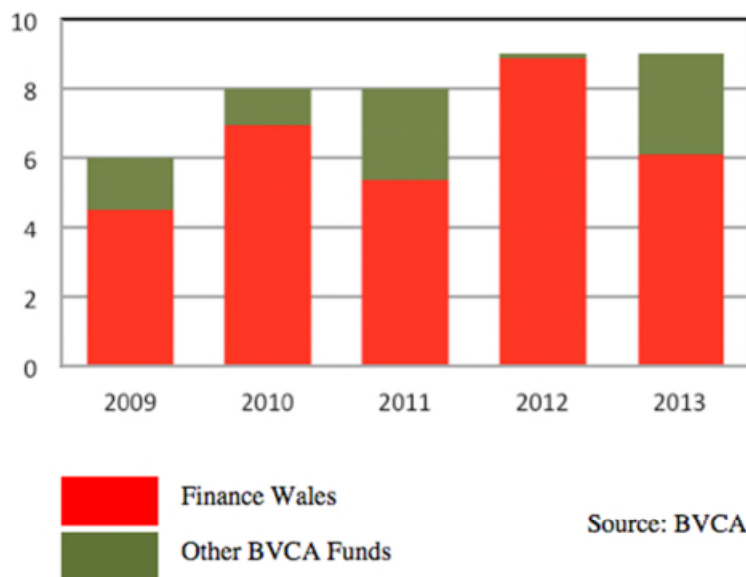
234. Government intervention at a regional level is appropriate to facilitate both the increase in capacity and capability of high net worth individuals to provide angel investment funding. Such intervention has been shown to be effective in increasing the skill base of investors, the number of active investors, and the degree of syndication between individual business angel investors and business angel groups, enabling high growth companies to access larger amounts of capital over longer periods of time, as well as hands-on mentoring and other practical business support.
235. Based upon appropriate supply and demand-side analysis, and establishing the case that there is the opportunity to increase both the supply and demand for equity investing into high growth potential businesses within Wales, there is a role for the DBW to stimulate more informal investment into Welsh SMEs by the following means:
- Encouraging more high net individuals to become angel investors;
  - Providing training and initial pump-prime funding to establish more angel groups and syndicates that these new angels can join and participate in;
  - Increase the general competency and capability of Welsh business angels through the provision of training, master classes, mentoring and linkages to international best practice;
  - Create a forum to bring together business angels to work together to improve their skills and to syndicate investment opportunities;
  - Through a better understanding of the needs of investors, substantially improve the quality of investment ready training to entrepreneurs;
  - Increase the linkages of Welsh investors to potential sources of follow-on funding within the UK and internationally.
236. This would differ from the current model adopted by Finance Wales where it actually owns and manages xénos, the Welsh business angel network. Instead, the DBW would therefore focus on “capacity building” by increasing the number and quality of angel investor groups as opposed to directly facilitating individual investment as is currently done through xénos. This would build on experiences of how this has been done elsewhere (Scotland, Ireland, Northern Ireland, New Zealand). It will result in:
- An increase in the number of visible and sustainable sources of finance for SMEs to target directly;
  - An increase in the number of new players qualified to become part of the UK Angel CoFund thereby enhancing and accelerating access to UK national funds by Welsh companies;
  - A focus on under-represented geographical areas or sectors;
  - Education for both investors and companies on angel financing thus improving efficiency and success;
  - A bigger deal flow by volume and value and supporting more companies for longer.

237. The main principle would be to provide sufficient support to allow the private sector to operate efficiently and cost effectively in an area of recognised market failure, and in a manner that encourages the private sector to focus on a return of investment resulting from successful investment outcomes rather than from fee generation from the process of investing.
238. This would be achieved through the creation of a Welsh Angel Capital Association to act as an umbrella organisation to encourage the development of multiple angel groups and networks, and the coordination of these together with family offices and individual business angel investors to work in a co-operative manner.
239. Full details of the business case for this organisation have been presented in a detailed paper to the T&F Group but the expected cost of developing this initiative would be around £250,000 per annum, part of which could be generated through sponsorship.

#### Venture Capital

240. Venture capital globally is often associated with technology start-ups that, as they grow, tend to require and attract highly qualified engineers, higher salaries, and requirements for service provision from other companies. Technology companies, if successful tend to grow more rapidly than other sectors, creating proportionally more new products and markets than larger companies. They become the launch pad for other innovative products and technologies and they help create a culture of entrepreneurship.
241. For the period 2009-2013 the main source of venture capital in Wales has been Finance Wales (Figure 4). There are few other venture funds operating in Wales with the exception of firms such as Welsh Fund Managers, Wesley Clover, Eden Ventures, and Westbridge Capital.
242. Over this period, Finance Wales has invested £58 million of private equity. Of this approximately £32 million was venture capital from five funds, namely the Interim Fund, the Jeremie Fund, the two Objective Funds and the Small Loans Equity Fund. More recently a sixth fund - the Technology Seed Fund - was launched in 2014.
243. However, the review has identified seven perceived weaknesses in the structure, practice and organisation of Finance Wales that, in the opinion of the group, lead to sub-optimal venture capital allocation and management. Blame is not expressed, as these weaknesses are the result of a mixture of forces, mainly the overall mandate of the organisation, its structure and certain constraints that do not allow best practice particularly in the area of financial incentives.

Figure 4. Finance Wales' share of venture capital in Wales, 2009-2013



#### *Dominant Ethos*

244. The overriding activity of Finance Wales is the provision of debt. Since its inception Finance Wales has invested over £400 million of which around £60 million has been private equity; of that £60 million just over half has been venture capital. Thus 85 per cent of the activity of the organisation has been the allocation and management of debt, an activity requiring caution and avoidance of risk. In complete contrast, venture capital investment requires an acceptance of risk.
245. The quantity of allocations is an important key performance metric for Finance Wales although in the venture capital world, quality is more important and insufficient management attention is paranoia for venture capital funds. A focus on quantity (i.e. spreading as much as possible over as many companies as possible) also flies in the face of another venture capital axiom namely not to invest in projects that are not fully understood.

#### *Performance Measurement*

246. Venture capitalists measure their performance using a standard set of venture capital industry measurements that are generally accepted globally as appropriate by the industry, its associations and its regulating bodies. These measurements are of importance to the limited partner funds that have invested in the fund.



247. Venture capital funds need to raise a new fund every five years or so. Without this, fees and investment capital will dry up and the fund will wither and die. Attracting new investment into new funds requires a range of demonstrable abilities but paramount amongst them is comparative investment performance. Thus fund managers are very much driven by fund performance, and, if they do not compare favourably, they will not attract new money.
248. Evidence from discussions with Finance Wales suggests that this pressure is lacking and there is no evidence that performance measurement was of any major concern for the organisation. Neither, it would seem, is comparative performance important in the attraction of new funds that is an allocation process at national and European level. Teams that are not measured by industry standards lack the motivation that comes from that activity.

#### *Financial Incentives*

249. Over the last five decades, a model for the financial motivation of venture capitalists has evolved and been perfected. The “2-20” model is generally accepted globally as best practice for maximising the manager’s performance. Between 2 per cent and 2.5 per cent of the fund size is paid by investors of the fund annually to cover operating expenses and salaries of the fund manager. Once the amount of the fund has been returned to the investors and the fund manager has recovered the accumulated annual expenses, the fund manager receives 20 per cent of all further gains. This is called “carry” and is the driving force behind fund management. The principle of 2 per cent expenses and 20 per cent carry “works” and a failure to use this model of compensation and incentive is not normal in the venture capital world.
250. Finance Wales does not use this model and instead pays a bonus on completion of an investment. This could be due to the fact that a separate compensation structure for a relatively small team would be untenable within the larger organisation. This may be appropriate for a loan manager but it is completely the antithesis of how to motivate a risk taker such as venture capitalist or a private equity manager

#### *Strategy*

251. The investment strategy of Finance Wales is extremely broad in its application, encompassing a broad array of private equity asset classes from venture capital, expansion capital to MBOs. This is very unusual as the skill requirement and experience to manage an MBO investment is very different from that of a start-up one.
252. There is great variation in size of the individual investments, i.e. individual placements ranging from £20,000 to £7.5 million in 85 separate companies. This is again is very unusual and reflects the great diversity of investment stage and sector that the fund is trying to invest in. In addition, almost all sectors

have been invested in (ranging from tourism to medical instrumentation to food and drink, to aviation services).

253. Within such an arrangement, it is difficult to see how a relatively small team can have as broad a sector knowledge as is demanded by the very different market and technology specifics of the projects, especially when it is commonly accepted that venture capital funds need to specialise. In addition, the remaining reserves in the currently managed fund is around £15-20 million, which is low given that the 85 companies already invested in will require follow-on funding.

#### *Creating New Companies*

254. During 2009-2013, Finance Wales invested venture capital in nine start-up companies as compared to the provision of debt finance to some 70 start-ups. An initial £3.6 million was invested in these nine start-ups with follow on investments of an additional £3.2 million at early and later stages.
255. Therefore in five years, only £6.8 million of the £58 million total equity portfolio of Finance Wales has been in brand new companies or (12 per cent of the total). Of the nine start-ups, three received 77 per cent of the £6.8 million, which is not an unusual distribution as investment is favoured for those start-ups that seem to be meeting their potential. In the same five-year period across the whole of the UK, BVCA members invested in 340 start-ups, twice the number of start-ups per 1 million of population.
256. The argument for skilled maintenance of the project after initial investment must again be emphasised as the more complicated technology and intellectual property-based start-ups will require a great deal of support, guidance and management from the investing fund. It is this type of start-up company that, although riskier, more expensive, and more difficult to manage, will create higher value jobs, associated infrastructure, and spawns other start-ups in the sector.
257. In summary, the management of the equity funds has tried to be all things to all people. Perhaps in a genuine effort to fulfil its mission, it has “tried too hard to do too much”. The Finance Wales team could not be expected to have the requisite degree of sector knowledge to make investment decisions in the wide categories of companies it has been investing in. Venture funds seek to specialise in a very limited number of sectors, where their knowledge and that of their networks will mitigate the risk inherent in initial investment decisions and, just as importantly, provide the experience and contacts needed to contribute to the management of the investee companies.
258. There are two sides to the problem of improving the situation for venture capital in Wales, namely the supply and availability of funds and the demand for venture capital from SMEs.

259. Quantitatively, there is sufficient supply, in that UK and European Union funding is available. The issue is not in how much funding is available but how the investment of the available funds is organised. It is the conclusion of the T&F Group that a single, large, centralised, entity such as Finance Wales is not the optimal vehicle of delivering venture capital.
260. Further, the necessary constraints and overall mandate of Finance Wales make it difficult for it to operate as a competitive venture capital fund and the financial incentive system it has adopted is not the standard venture fund package of “2+20” that has become the global norm for management of venture capital.
261. Given this, it is proposed that the structure of the current organisation should be reconfigured and replaced with separate entities designed to concentrate more on expert knowledge and on the unique regional social and economic parameters of Wales. The management of venture capital should also be moved one stage further away from government, thus allowing more independent management particularly in the area of financial compensation.
262. The overall effect of these suggestions is that the Welsh Government, via the DBW, becomes a limited partner investor in a series of venture capital funds specialising in different sectors and stages of investment. In this respect, a number of actions are proposed:

*Attract Proven Venture Capital Funds to Wales*

263. Currently Finance Wales is investing venture capital across a very wide range of sectors and stages. It is difficult to see how its staff could have the required levels of experience and qualification to judge and administer such differing opportunities. The proposal here is to seek to attract established and successful UK or international funds that specialise in stage and sector. The sectors would ideally be those requiring the higher levels of technology. This approach is similar to the 2013 creation of the Wales Life Sciences Investment fund managed by the Arthurian Life Sciences fund. Two separate stage funds are suggested below.
264. *Technology Start-up Fund* - Start-up funds, concentrating solely on that stage are rare and a challenge for start-up funds has always been avoiding being heavily diluted or even wiped out by later stage investors. This is the case, for the start-up fund, of failure bred by success and happens in successful projects where the product or technology has been developed, the market is receptive and more finance is required for ramping the company. One response has been to budget to invest over the life of an investment project but this severely restricts the number of start-ups that can be generated. A scheme whereby the Welsh government or an agency could co-invest at a later stage with the start-up fund would alleviate this problem and lead to more capital

being deployed. The size of fund could be £10 million to £15 million on standard venture capital industry terms.

265. *Specialist Technology Later Stage Fund*. This would be similar in concept to the start-up fund above but investing at a later stage. The size of fund could be £15M to £20M on standard venture capital industry terms.
266. In the case of both of these funds, an independent fund will not invest for any other reason than perceived success. There will be no pressure accepted that the fund has to be deployed and, if the right kind of project is not available, the capital will not be called.

#### *Expansion and Growth Capital Debt Fund*

267. Over 2009-2013, Finance Wales has invested some £22m of private equity in expansion and growth opportunities. Expansion and growth capital are at the lowest risk stage than venture capital investments, and a fund would normally make these in companies it had already invested in at earlier stages. Clearly from a portfolio management point of view this makes eminent commercial success and will increase the chances of a successful return for the fund. Expansion and growth investing is, compared to venture capital, relatively low risk “easy pickings”. In the organisation of investment outlined by these suggestions, there is no room for low risk fund maximisation. The contracted funds will have a specific stage mandate and, whilst they may want to invest in the much later growth stages of a company, should be encouraged not to.
268. In order to maximise the number of projects of the venture capital funds, the expansion and growth capital would ideally be debt. The suggestion here is that a debt fund be created specifically to provide later, lower-risk debt funding to companies created and maintained by venture capital funds. A second role for this debt fund would be to convert all or part of the equity held by venture capital funds into debt. This would be specifically in the cases of companies that are viable or close to viability, but which are unlikely to grow to a size where a successful venture exit is possible.
269. Even after such a transfer these stable low-growth (SLOG) companies would remain in the portfolio of the venture fund that could continue to manage the project and receive some fees for that management. These companies are likely to be technology companies and are likely to have developed some intellectual property which could be taken as collateral. The exact details and rules for application of this transfer vehicle need to be designed by the appropriate financial experts.

#### *Network of Micro-Venture Capital Funds*

270. The proposal will approach existing or potential angel investors and incentivise, develop and support them to become small-scale venture funds. The funds

would be organised on a sectoral and regional basis and the network would need a central coordinator and back office within the DBW which would initially provide some development in initial investment analysis techniques, typical financial and legal vehicles used by venture capital funds and in what is expected in terms of managerial support and mentoring. Once established, the back office would ensure regular reporting and financial management for each individual fund.

271. The stages to be targeted by the network would be start-up and early stage and the target size for each fund would be in the region of £3 million. The individuals appointed would be expected to raise around 25 per cent of the funds (approximately £750,000) themselves. Terms would be standard venture capital fund terms namely 2.5 per cent of the fund (higher than normal due to small size of the funds), or £75,000 per annum for salaries and expenses. These would be 5 to 7 year funds with a return of capital and expenses to the DBW before a 20 per cent carry is applied. Exits for the type of company being invested in may well prove problematic, and as in the case of any start-up stage fund contracted as suggested earlier, it may be necessary to provide a debt for equity transfer that improves the chances of the fund proving successful in terms of capital returns and carry. This is a key component of this suggested scheme and of attracting start-up stage funds and will require solutions designed by appropriate specialists.
272. The network would not be expected to be committing large-scale investments and would concentrate on opportunities leading to viability after around £250,000 to £500,000 had been invested. Projects that might grow past these stages might attract investment from other funds.
273. The main role of the DBW here is as a limited partner investor. For ten funds, the capital requirement over five years would be £22.5 million and the fees over 10 years would be a further £7.5 million. The network could be introduced gradually, with an initial pilot scheme of a minimum of two funds in the key sectors identified by Welsh Government (such as creative industries or environmental firms) and expanded if the evidence supported this.
274. The main conclusions regarding venture capital development for Wales in the future are as follows:
  - In order to create high growth firms in Wales, there needs to be a greater focus on venture capital rather than the MBO and expansion capital which has been the focus of public funded equity programmes to date.
  - It is sub-optimal to attempt to manage venture capital funds in an organisation such as Finance Wales where the predominant culture is debt allocation and which prohibits the use of best practice financial incentives.

- To be effective venture capital needs to be specialised in terms of stage, and particularly in terms of sector. Risk mitigation requires investing teams to have a ‘deep domain’ knowledge of their chosen sector. In Finance Wales the opposite seems to be the intention, namely to invest where investment is required rather to invest in projects which are understood and can be fostered.
  - Initiatives need to be taken to further and urgently develop a “culture of entrepreneurialism” in Wales.
275. Therefore, venture capital in Wales should be outsourced to a network of specialist funds, particularly in the technology sector. New financial vehicles which balance the (sometimes) conflicting objectives of financial return and employment retention need to be designed and implemented in the terms of any government investment in these funds. In addition, a network of micro-venture capital funds with regional and sector focus should be set up using as one source the angel investment community.

### ***Exporting SMEs***

276. The capability and capacity of SMEs to internationalise is a key requisite of a competitive regional economy although according to HMRC data, Wales had as few as 1,711 active exporters in 2014 with only the North East of England and Northern Ireland performing worse.
277. To support exporters, the UK Government provides financial guarantees and credit insurance through its export credit agency UK Export Finance (UKEF). Its role is to help exporters and investors by providing credit insurance policies, political risk insurance on overseas investments and guarantees on bank loans. More specifically, it (a) insures UK exporters against non-payment by their overseas buyers; (b) helps overseas buyers to purchase goods and services from UK exporters by guaranteeing bank loans to finance the purchases; (c) shares credit risks with banks to help exporters raise tender and contract bonds, in accessing pre- and post-shipment working capital finance and in securing confirmations of letters of credit; and (d) insures UK investors in overseas markets against political risks. In 2013-14, it offered guarantees and insurance policies of £2.32 billion to UK exporters, although no separate information on support for Welsh businesses is available.
278. Initially, the main demand for UKEF support was on sharing risk on contract bonds; more recently, working capital guarantees have become of increasing interest, perhaps because exporters are accepting that they may need to offer deferred terms of payment in order to win more business. It appears there is less demand for UKEF’s trade credit insurance cover, as the private insurers seem able to accommodate much of the demand under current market conditions.

279. UKEF has one Export Finance Adviser for SMEs in Wales (and shares with the Midlands and the West Country a further Export Finance Adviser focused on larger exporters). This adviser works alongside the Economy, Science and Transport Department's Trade and Inward Investment team in Cardiff, which has two members, with a third member covering North and Mid Wales. It is estimated that the UKEF Export Finance Adviser generates about 40 per cent of the inquiries he receives from his own activities, 40 per cent from banks, and 20 per cent from the Trade and Investment team, with occasional inquiries passed to him by Business Wales.
280. Access to finance is key to many exporters and again the question arises whether the DBW should develop its own capacity to support greater internationalisation by Welsh SMEs or whether it should work alongside existing providers of support to the banks such as UKEF. At this stage of the development of the DBW, it is proposed that the latter approach is adopted. As the Access to Finance review suggests, the DBW should take responsibility for ensuring that the products of UKEF are marketed effectively within Wales in tandem with UKEF and Business Wales so as to drive forward internationalisation in the economy and the benefits of higher efficiency that exporters competing in a wider market can obtain.

### ***Social enterprises***

281. Wales has over 33,000 organisations in the social sector, whether charities, charitable companies, community and voluntary organisations, and social enterprises. The sector is facing growing challenges as public sector expenditure is being cut. Organisations may choose to adapt to these new circumstances by finding new ways of raising revenues and/or delivering services to their users.
282. Specialised social purpose banks are working to respond to the difficulties in securing senior-ranking term debt on appropriate terms from the high street banks that are faced particularly by smaller social sector enterprises.
283. Aside from grant funding from trusts and foundations, the scarcest form of finance has been equity and high-risk junior-ranking, mezzanine-type debt. This is provided by a small number of existing alternative providers (such as Big Issue Invest and CAF Venturesome) that are being joined by new debt funds being supported by Big Society Capital.
284. Greater availability of finance in this form should also be encouraged by the introduction of the Social Investment Tax Relief measure announced by HM Treasury. This is designed to stimulate investment by individual investors in equity and certain forms of high-risk debt for charities and social enterprises as a counterpart to the long-established support for investment in private sector firms through the Enterprise Investment Scheme.

285. But it can still be difficult for social sector organisations to work out how best to address the challenges they face or change their business models to meet those challenges, to identify the right forms of finance that would best meet their needs, or to gain access to the new forms of finance becoming available.
286. Given this, there is a clear role for the DBW to give social sector organisations guidance and sign-posting support to providers of advice on how to become 'investment-ready'.

## **5.2 Existing financial provision**

### ***Welsh Government Grants***

287. Within the Access to Finance review, it was envisaged that all funding for SMEs currently managed by the Welsh Government should be brought under the auspices of a new DBW. This would include the various grant programmes currently managed in-house by the Department for Economy, Science and Transport. There are three options for the Welsh Government in considering this.
288. The first is to transfer Welsh Government business grant teams into the DBW. This may be difficult in the short term and it is uncertain whether the various grant programmes – such as the Economic Growth Fund – could be transferred to a new independent body given financial and legal restrictions
289. The second is to do nothing and treat grants as separate from the DBW. This could result in continuing confusion over funding given that grants are aimed at specific sectors and lead to SMEs going for the easiest option first (i.e. grant)
290. The third option is retain the grant teams in-house or within WG's delivery contractors but the marketing and promotion of the grant funding is done through the DBW. In addition, a MOU should be set up between the DBW and the Welsh Government grant teams to use the same due diligence process, i.e. one borrowing event, one process.
291. This would be the preferred option in the short term as it is the most effective way of ensuring a consistent brand, getting Welsh Government to work across organisational boundaries and reducing the cost of due diligence.

## **5.3 Finance and business support**

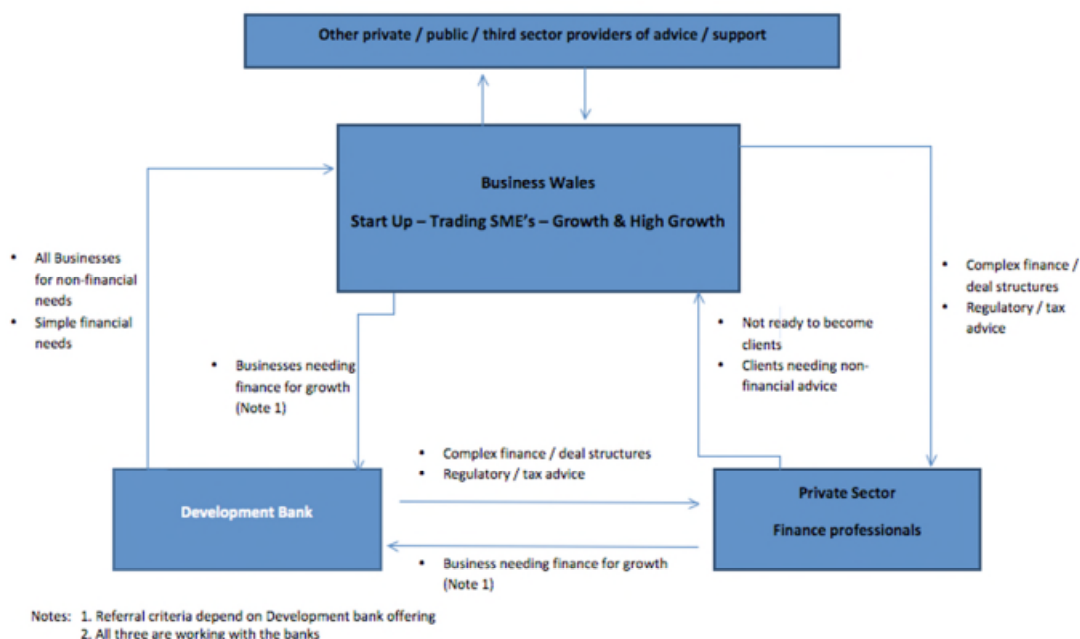
292. With an objective to promote the SME finance market in Wales, the role of the DBW could naturally be expanded to include the delivery of non-financial services such as business development, training and mentoring, investment readiness of the demand side and capacity building on the supply side. In most



cases, the costs of these services are absorbed directly by PDBs and include a wide range of activities to support their own network of private sector firms through which the financial product is delivered to the target market segments of the PDB. The purpose is to help transfer knowledge and best practices to strengthen and build the capacity of the private sector to provide financial services to the target.

293. One of the key recommendations and principles of the Access to Finance review was that business and skills support should be offered alongside financial support to businesses, including voluntary, community and social enterprises in Wales. This follows research that shows those various public organisations involved in supplying financial support to such businesses should also provide various types of business support to their clients.
294. The decision therefore is whether such business support should be integrated into the DBW as a separate function or whether it should essentially be working alongside existing providers to supply these services to businesses as part of an integrated package.
295. The T&F Group received a paper describing the current support structure in Wales for SMEs in the private and public sector. It concludes that the majority of advisory support needed to enable a Development Bank to function effectively, as part of the wider spectrum of finance for business, is already in existence. These recommendations seek to avoid expensive duplication and make what exists function better for the benefit of businesses.
296. Currently business advice (including financial) is provided by the Business Wales service, which is contracted out by the Welsh Government. It is the opinion of the T&F Group that at this stage, the focus of the DBW should be on becoming the primary source of financial support in Wales. There are also issues that may arise which would cause difficulties in the DBW taking on any direct business functions, such as the need to ensure compliance with the requirements of the Financial Conduct Authority. There may also be the temptation to rebuild a wider advisory service to accommodate other business needs, duplicating effort and wasting public funds when the aim of the DBW is to be efficient and effective in providing financial support to businesses.
297. With business support already in place, such a service would duplicate existing services that have made considerable progress in the last few years in raising awareness in the market. There is also a requirement for financial advice not to be isolated from general business advice, especially for many microbusinesses.
298. There would be the danger of introducing further complexity into the government support landscape that, as the 2012 Micro Business Task and Finish Group Report noted, should be avoided. Figure 5 shows a potential structure of business and financial support to Welsh SMEs that encompasses Business Wales, the DBW and the private sector.

Figure 5. Proposed structure for co-operation in business support in Wales



299. The interaction between DBW and the BW programmes should be properly resourced and led by a senior person in each body, so ensuring referrals in both directions. In addition, it would be expected that senior officials within Business Wales would be part of a wider operational group for the DBW so as to ensure that both organisations work closely in delivering the best solutions for Welsh SMEs. In addition, clear responsibility for interaction with private sector financial advisors through the relevant professional bodies such as ICAEW and ACCA should also be part of this remit.

300. Outside general business support, there has been discussion as to whether the DBW should, as part of its remit, supply specific non-financial support to investee companies (i.e. money with management) to enhance the success of the implementation of the investment, improving business performance and ultimately improving the prospects of repayment and realisation of the investment. Whilst this would normally form part of any equity investment (with the venture capitalist providing this service), the same may not be the case in terms of debt finance.

301. But, for example, to help entrepreneurs accelerate growth, improve productivity and build organisational capabilities, the Business Development Bank of Canada (BDC) offers technical assistance to borrowers in the form of management consulting to help strengthen the capacity of its entrepreneurs. As a result, BDC clients who received financing and consulting achieved 60 per cent higher revenue growth, employment growth and survival rates than non-BDC clients.

302. Subsidised consultancy support could be offered to supplement the Business Wales SME and Accelerated Growth programmes, especially to those businesses that have been identified as needing to strengthen their management team if the funding they receive is to be fully maximised for the benefit of the business. In addition to consultancy, such support could also be offered through business advisors or mentors or possibly through part-funding the appointment of non-executive directors. In order to facilitate such a service, the DBW could offer specific grant support that could be added to any financial agreement for funding developed through any of the previous financial products.

#### **5.4 Research and evaluation**

303. The Access to Finance review noted that information on funding for SMEs in Wales was very difficult to obtain from financial institutions. This is not an isolated incident - the independent lending review of RBS, chaired by Sir Andrew Large, also emphasised that data gaps in the make-up and performance of SMEs and their financial requirements impede policy-making and credit-decision making in the UK. In addition, the British Business Bank recognised that in order to deliver its objectives there was a real need to strengthen its strategy/policy functions so that it could anticipate and act on any changes in the marketplace or the economy and help develop a strong case for any appropriate interventions for Welsh business.

304. The T&F Group agreed that the DBW should have an independent research department of the highest quality. This would enable information to be collected to inform the strategic direction of the organisation as well as enabling to "own" Welsh SME financial statistics and give the DBW credibility in the market place.

305. Therefore, a key role for any new development bank is to have a research and evaluation function that provides thorough understanding of the SME market in order to develop new products, services and financial platforms. This will enable it to generate new ideas to enrich the knowledge base that supports the policy agenda of the DBW and the Welsh Government. This is currently a function that is largely absent from Finance Wales and the Welsh Government and could provide detailed knowledge of the SME sector in Wales and, at the same time, ensure that there is another independent economic analysis that can help in interpreting economic trends and their impact on businesses. For example, there has been little detailed research undertaken, outside of the Access to Finance review, on the financial needs of SMEs in Wales.

306. This function should also, independently or with external organisations, constantly evaluate the impact of the DBW's various programmes and further

improve their performance. Part of this role would include undertaking market research and evaluation of clients to ensure that the DBW is delivering its products and services efficiently and effectively.

307. It would not operate in isolation but would involve partnerships with a number of leading academic institutions in Wales and further afield (including Cardiff Business School and the banking group at Bangor University) and further afield to provide research capability through direct contracts or seconded staff. There may also be an opportunity to work selectively with the research departments of a small number of global investment banks, as well as co-operating with the BBA and BDRC International on the SME Monitor.

## **5.5. Outreach programmes**

308. Whilst it is not recommended that the DBW should take over the function of Business Wales to provide direct business support to SMEs in Wales, there is an important role for the DBW in promoting best practice amongst financial intermediaries and investors in Wales or coming from elsewhere to invest in Wales as well as amongst businesses themselves.
309. Private sector investors frequently cite the lack of investor readiness, as a major inhibitor to investment and enabling a supply of high quality deal flow is a primary requirement for growing a local investment community and attracting investors to the region. It is proposed that the DBW becomes involved in key investor engagement activities of preparing a particular company to engage with the particular type of funding provider, working closely with the advisers in each Business Wales programme. This assistance should be open to all SMEs at a regional level as necessary and should be put in place before the need for external finance is raised. Companies should potentially be able to seek assistance several times as they grow and the nature of their funding needs change and any programme introduced to support investor readiness should be designed to reflect this.
310. Non-financial support also needs to include the “capacity building” on the supply side. For example, this could include activities to increase the number and quality of angel investor groups as well as increasing the general competency and capability of business angels through the provision of training, master-classes, mentoring and linkages to international best practice. Not all private wealthy individuals can be angels and any programme aiming to create a viable angel community seek not just to increase the amount of cash available for investing, but also seek to encourage “the right type of angel”, i.e. those who are willing and able to be active both in the sourcing and screening of deals and in mentoring the company post investment. There is a steep learning curve required to understand how to source investable businesses, carry out screening and due diligence, and learn the intricacies of valuation

and deal structuring. All of this must then be combined with the skills necessary to support a business post-investment with mentoring and advice over the likely 5 to 10 years it will take to achieve a successful exit.

311. A more radical approach would be to fund parts of the investment chain that currently deter potential investors. It is also proposed that this should be done with angel networks; but it could also be achieved by supporting due diligence providers or opening up access to a credit rating platform for Welsh SMEs. The DBW could also support the development of the financial ecosystem through encouraging the development of SME-focused providers such as start-up consultants, business plan writers, and those firms involved in supplying non-executive directors for growing businesses.

## **5.6. Stimulating demand in the marketplace**

312. There are two aspects to stimulating demand in the marketplace for finance. The first is better promotion of the financial options open to SMEs in Wales. For example, a recent report from BIS shows that SMEs are generally not aware of the existence of government finance schemes and how to access funding. The DBW should take a lead in working with intermediaries, business groups and other organisations in promoting not only the products and services it offers but the range of financial solutions available to SMEs in Wales. In this respect, it could adopt an 'investing in investment' approach where it acts as a clearing house linking supply and demand, signposting sources of finance to business, advising on financial options, referring business to finance providers and championing the use of alternative finance nationally.
313. Secondly, the DBW must play a major role in stimulating interest in new venture creation and business development across Wales. It is noticeable that Finance Wales has not been as prominent in this role as it should have been. This is not only in terms of promoting its own products and services but also in supporting Welsh business more generally, although it has recently become more involved in sponsoring various business awards. It is also surprising that it has failed to properly engage with social media given their growing importance in communications with stakeholders. For example, its Twitter account was set up in October 2009 but only became active five years later. Similarly, its LinkedIn account was only established ten months ago and whilst it has a presence on Facebook, it has made no posts.
314. There clearly needs to be a step up in promoting and stimulating finance for SMEs in Wales and a new DBW would be fully engaged in marketing only itself and its products but the financial sector and business in Wales more generally, especially in terms of investment readiness. A full appraisal of the marketing position to be undertaken by a new DBW needs to be undertaken once the organisation is established. In addition, there needs to be innovation in funds

and also in the promotion and stimulation of demand to get the attention of potential entrepreneurs and the wider public and to attempt to engender a culture of entrepreneurialism quickly. Two ideas have emerged from the group that are radical but could be taken forward by the DBW, as set out below.

315. *The Entrepreneur Lottery* - This suggestion involves the establishment of a national Welsh lottery aimed at identifying and encouraging the demand-side for new ventures in the region. The lottery would be run every two months for a year and the first and only prize would be £50k. The lottery would need to be well publicised and would require participants to complete a simple business plan of one page. Required metrics would be description of product or service to be developed, location, estimate of costs and revenues per annum over the first three years of operation, and potential employment over the first three years. It will be made clear that no assessment will be made of the idea as it is a lottery not a competition or an application for a grant, and there is no judgement involved. All entries would go into a “digital hat” and the winner would receive the £50k over time against the submission of invoiced expenses associated with the start-up. Managerial and sectoral help will then be assigned to the winner from available sources. Applicants or “players” will be asked to tick a box should they be prepared to allow, in the case of not winning, their plan to be passed to other sources of start-up finance in Wales thus generating interest in new businesses. Such an initiative will draw attention to the fact that there are sources of finance available for new ideas and will help to gauge the level of entrepreneurial energy in Wales. It will also show that the Welsh Government is willing to try new ideas itself to encourage greater entrepreneurship. After running the lottery bi-monthly for a year for a cost of £300k plus administrative costs, there would have a clear, bottom-up, market survey of the strength of entrepreneurial zest in Wales.
316. *Televised Crowdfunding* - The television programme Dragons Den will form the basis of this idea but with a significant difference. A high street bank will be approached to be the senior sponsor with some funding from the Welsh Government. The costs will have to be covered but more importantly, a capital fund of approximately £300k. The programme will only be televised once and the entrepreneurs will be interviewed as on the normal show but then, instead of choosing a winner, the viewing Welsh public will be invited to invest in the companies via crowdfunding via telephone. Shares will be priced at £1 and for each share an investor buys they will receive another one, free, paid for by the sponsors. There are significant obstacles to this project (including regulations on investment advice, choosing companies with the possibility of some kind of exit), although it would, along with the lottery, show the Welsh public in a comfortable, non-boring format that enterprise creation is happening in Wales.

## 5.6 Stakeholder management

317. The new DBW would need to interact regularly with key stakeholders such the Welsh Government, the National Assembly for Wales and the UK Government; the business community and new entrepreneurs; banks, intermediaries and other financial organisations.
318. The Welsh Government will be the sole shareholder of the DBW and it is critical that the DBW is aligned with its priorities going forward. However, evidence to the T&F Group suggested that there had been poor alignment between Finance Wales and the Welsh Government's sector panels and the city region boards.
319. Testimony from the sector panels suggest their companies have different financing and business support needs and the role of the DBW would be to work closely with the panels to ensure that there is access to the most appropriate type of funding required by firms operating in different sectors. For example, whilst venture capital funds may be relevant to digital, life sciences and environmental science firms, the guarantee scheme may be what is appropriate to tourism businesses whilst the enhanced invoice finance proposal could suit larger SME manufacturers. In this respect, part of the research and development function of the DBW would be to maintain intelligence on the financing market (for different segments) and to highlight the development opportunities in finance back to the sector panels.
320. The DBW could actively draw on the sector expertise in the Welsh Government sector teams. This would be done by having senior staff work alongside the respective sector teams and in this way, there is a close relationship between the two as the DBW can act as experts in financial strategies to accomplish the sector panel aims, namely reporting on the current state of the financing market; potentially raising or managing funds; or enabling the sector panels to commission third-party fund-providers and providing oversight.
321. Similarly, there is evidence that a good working relationship with the two new City Region structures could provide opportunities to use existing sub regional networks, thus providing contact interface with targeted SMEs in a cost-effective way and helping to establish a pipeline that effectively identifies opportunities. There would be significant potential and opportunity for the City Region Boards to share their priorities with the DBW and ensure awareness of specific regional activities. The City Region Boards have to evaluate a number of projects against their potential to generate significant regional impact in line with their key aims. This should ensure that resources (including DBW support to SMEs) could be targeted to deliver outcomes that contribute to the city regions' strategic priorities.
322. In addition to working closely with the Welsh Government, there needs to be a better relationship with the National Assembly for Wales. As has been

discussed in terms of the governance of the DBW, the chairman and CEO will appear annually in front of the NAFW's Enterprise Committee to present a report on progress. There will also be regular information provided to Assembly Members on the work of the DBW.

323. Closer relationships need to be established with other providers of finance to SMEs, especially given the proposed hybrid model that has been recommended as the main form of delivery for the organisation. The Access to Finance review has already noted that banks and the Welsh Government should not operate in isolation in terms of the provision of finance to SMEs.
324. Following the first stage review, there have already been negotiations between the Welsh Government and one of the high street banks to develop a referral system for those turned down for bank lending, although closer links between business support and access to finance could also sustain this process. In addition, another bank has stated its intention to work closely in developing the potential of growth businesses in Wales.
325. Regular formal meetings should take place every six months between senior officers at the banks and the DBW to discuss the challenges facing the Welsh economy and the way to address these challenges together. There also needs to be a continuous dialogue not only with other development banks in the UK such as the British Business Bank and the proposed Scottish Development Bank, but also with financial intermediary organisations such as the ICAEW, ACCA and the NACFB.
326. There needs to be better relationship management of external finance. As the Access to Finance review noted, there are various British Business Bank-supported financial initiatives where Welsh businesses have not been as successful as expected. Whilst this is reflective of the wholesale model adopted by the British Business Bank, there can be role for the DBW in encouraging firms to examine Wales as a region for future investment.
327. It was recognised during the review that not only is the development of Welsh entrepreneurs critical to the future of the Welsh economy but that the Welsh Government must look to attract entrepreneurs from outside of Wales to relocate here. In this respect, the DBW has an important role to play, not only in providing the appropriate finance through its vehicles but, more importantly, in acting as a catalyst in doing this. It needs to develop strong relationships with organisations such as the Alacrity Foundation, which develops teams of talented graduates to form new businesses in Wales, and Invest UK that brings together foreign investors and UK investment opportunities.
328. It is not only within Wales that the DBW has to influence financiers as there is a need for Wales to properly relationship manage potential investors and bank lenders in the City of London for investment and profile purposes. This means a continuous programme of engagement beyond seeking direct investment



opportunities. Instead, there needs to be a consistent and constant dialogue on Wales and the investment opportunities. From this foundation, the DBW needs to bring investors to Wales to present them with investment-ready opportunities, and to be taking groups of investment-ready Welsh companies up to London.

## 6. NEXT STEPS

### 6.1 Introduction

329. The previous sections have shown that there remains a funding gap for Welsh SMEs that is not being addressed by the public or the private sector. There are significant parts of the SMEs market, especially microbusinesses, which are not being supported despite their capacity to create jobs.
330. To date, the Welsh public sector response has been undertaken in isolation from the private sector and has largely ignored market changes that have, since 2008, limited funding to SMEs. There is also room to improve the utilisation of private sector funding in the form of informal investors and venture capital to boost high growth firms that can have a disproportionate effect on the economy.
331. The creation of one organisation - the DBW - that can work towards closing the funding gap and help deliver funding to Welsh SMEs, including charitable, community and social enterprises, should be the aim of the Welsh Government. It needs to be an organisation that directly addresses the supply and demand dynamics of the Welsh SME finance market, is flexible in developing solutions that address market needs, is able to mobilise Welsh and external financial sources, and is co-operates with business support providers.
332. This will require an organisation that is built around a business model, structure and culture that needs to respond to a very different set of market dynamics when compared to the challenges that were faced by Finance Wales. It will also provide a more holistic approach and thus enhance the capability of the Welsh Government to support SMEs in Wales (Figure 6).

Figure 6. A comparison of the aims of the DBW and Finance Wales.

Aim	DBfW	FW
<b>Public accountability</b>	Governance and public transparency incorporated into remit	Recently improving
<b>Efficiency</b>	Self-financing within 5 years	In receipt of WG subsidy
<b>Focus (customer market)</b>	Wales – focused on government-set sector and regional priorities	Wales + English regions – general micro-medium enterprises
<b>Supply finance</b>	Equity, debt, asset-based, alternative, social, public programmes	Equity, debt, some public programmes
<b>Supply support</b>	Fully integrated/ aligned	Some links
<b>Stimulate demand</b>	Market out-reach, training & education	NA
<b>Market development</b>	Diversification of financing and support business	NA
<b>Links to mainstream finance</b>	Active relationship-building and investment origination	Some fund investors
<b>Understanding market needs</b>	New research function	NA

333. As the previous discussion has shown, it could be possible to merge the functions of Finance Wales into a new DBW as an option going forward. Fortunately, a precedent already exists for this type of organisational restructure following the takeover of Capital for Enterprise Ltd by the British Business Bank. This gives the Welsh Government the opportunity to liaise with British Business Bank officials for advice and guidance as how to best organise such a merger.

## 6.2. Managing existing funds

334. As table 1 shows, there are a number of debt and equity funds currently being operated by Finance Wales on behalf of the Welsh Government that the new DBW may have to manage going forward.

Table 1 – Live funds currently managed by Finance Wales.

Programme	Eligible Sectors	Fund Size	Minimum Funding	Maximum Funding (in one round)	Anticipated Closure date
Wales SME Investment Fund	All Welsh SMEs (with some exclusions)	£40m	£50,000	£2,000,000	Aug-17
Micro-Business Loan Fund	All Welsh SMEs (with some exclusions)	£6m	£1,000	£50,000	Dec-17
Wales Property Development Fund	Welsh SMEs in property development	£10m	£50,000	£2,000,000	Mar-18
Life Sciences Fund	Life sciences firms based in Wales.	£100m	£250,000	£2,000,000	Feb-18
Wales Technology Seed Fund	Welsh technology start-up companies.	£7.5m	£50,000	£150,000	Jun-19
JEREMIE Fund	All Welsh SMEs (with some exclusions)	£150m	£5,000	£2,000,000	Sep-15
Small Loan Fund	All		£5,000	£2,000,000	Rolling Fund
Rescue and Restructuring	Welsh SMEs classified as a firm in difficulty		No min	£2,000,000	Rolling Fund
Help to Buy Wales	Housing/Mortgage Loans		No min	£60,000	Dec-16
Wales Capital Growth Fund	Welsh SMEs and larger business providing economic benefit	£20m	£50,000	£2,000,000	Rolling Fund

335. If Finance Wales is subsumed into the new DBW, then given the strategic priority of working with the private sector to fill a gap in the market, consideration must be given as to whether these funds continued to be managed by the new institution given the high management costs associated

with this approach as discussed in a detailed paper presented to the T&F Group. For example, in terms of the eighty existing venture capital projects in which Finance Wales has invested, there are three potential outcomes:

- *Residue Fund*: To continue to be managed by Finance Wales or its successor where the number of projects retained would be a number that can be appropriately and properly managed by the existing Finance Wales staff.
- *Secondary Fund*: Seek a secondary transaction to sell a portion of the fund projects to other venture capital funds in the UK or overseas. It is likely that there will be a loss on this transaction.
- *Transferred Fund*: Transfer some of the projects to venture capital funds that have been contracted by a new DBW.

336. As the focus of the new DBW should be on supplying financial support and advice to Welsh SMEs, it is recommended that if the existing funds for Finance Wales were to come under its remit, then the “Help to Buy Wales” should be transferred to another part of the Welsh Government as it does not fit into the core business of the DBW.

337. During the last fourteen years, Finance Wales has built up skills and expertise in managing public sector funding programmes in Wales and it is important that, where possible, these are retained especially in areas such as risk and portfolio management, as well as key administrative functions. However, in order to achieve the aims of the new DBW, it will also be necessary to recruit staff from outside the Welsh Government to ensure that the right skills mix is achieved and the best talent is appointed to manage the DBW.

338. If the Minister approves the establishment of a new DBW, it is proposed that a chief executive and chairman are appointed as soon as possible to head up the interim organisation. They will then form part of a project board that will be responsible for managing the development of the new organisation, including the development of a business plan for the DBW, the appointment of senior management staff either directly or through transfer from Finance Wales, and arrangements for the launch of the DBW. The project board will also consist of Welsh Government officials and externally appointed experts to advise on the creation of the DBW. A full-time project manager will be appointed to oversee the process.

339. This interim board will enable a new structure to be developed for the DBW that is separate to the fund management role of Finance Wales and create a single team that is working together within a new structure. The chairman or senior director of Finance Wales will be invited to sit on the board.

340. It would be expected that new DBW would be housed in the same building in Cardiff as Finance Wales to ensure that transfer of functions is achieved efficiently and effectively.

### **6.3. Cost of new funds**

341. Several new funds have been proposed for the new Development Bank and these will be the subject of negotiations with officials at Welsh Government and the Welsh European Funding Office (the organisation responsible for the management of European Structural Funds) regarding their funding. Various funding routes have been identified to support these funds going forward including European Structural Funding as well as internal WG funds.
342. There are currently plans to have two main funds as financial instruments for the next round of European Structural Funds, namely a £70 million debt fund and a £45m equity fund that would be focused on innovation. Both of these funds could be utilised within the new DBW to fund (a) the microloans funds and (b) the three equity funds proposed. Discussions will need to take place with the Welsh Government over funding arrangements for the 'flexible funding' debt funding which will be either guarantees or subordinated loans and whether these could form part of this funding.
343. This could be feasible for the equity funds as long as the DBW has an input into how these funds are organised as discussed earlier. However, given the structure proposed for both the microbusiness fund and the flexible funding approach, there may be issues with the debt funds if the DBW does not manage these financial solutions in some way. If this proves difficult, then alternative strategies may need to be adopted for EU funds such as limiting these to a number of key sectors or, as discussed earlier, setting up a specific fund for high risk businesses, which would build on the JEREMIE programme.
344. This could result in the DBW having to make a case to the Welsh Government for funding support, potentially via sources such as the Financial Transaction Fund.

### **6.4. Administrative costs**

345. As noted previously, there are savings that can be made in administrative costs if Finance Wales becomes part of the DBW. A detailed business plan will examine what administrative savings can be made as a result of any merger and its potential impact on the operational efficiency of the DBW going forward.

### **6.5. State Aid**

346. Following initial discussions with the British Business Bank, further clarification will be needed as to whether the DBW will have to be EU State Aid-compliant as an organisation to be able to undertake its role as discussed. Currently, all of the funds being managed by Finance Wales are State Aid-compliant and it is unlikely that this status would change going forward. If separate State Aid

approval for the DBW was required, then the organisation would adopt the same approach as the British Business Bank, namely once an interim organisation has been established, to start developing institutional capabilities and marketing the brand to SMEs.

## 6.6. Timetable

347. The following indicative timetable is proposed for the creation of the new DBW and for transition arrangements with Finance Wales.

Month 1	Minister announces new Development Bank for Wales Regulatory approval application (if needed) Recruitment of interim chairman and chief executive
Month 3	Publishes strategy and objectives of the new DBW Interim organisation established Chairman and chief executive announced Recruitment of interim board and key executive staff
Month 6	Appointment of interim board and key executive staff Development of management arrangements for new funds Agreement with Welsh Government and WEFO over future funding
Month 7	Business plan completed
Month 8	New funds launched
Month 9	Transfer key functions from Finance Wales into DBW
Month 10	Regulatory approval received (if required)
Month 12	Official launch of Development Bank for Wales