Cynulliad Cenedlaethol Cymru
The National Assembly for Wales

Y Pwyllgor Cyllid
The Finance Committee

Dydd Mercher, 26 Mawrth 2014
Wednesday, 26 March 2014

Cynnwys
Contents

Cofnodir y trafodion yn yr iaith y llefarwyd hwy ynddi yn y pwyllgor. Yn ogystal, cynhwysir trawsgrifiad o'r cyfieithu ar y pryd.

The proceedings are reported in the language in which they were spoken in the committee. In addition, a transcription of the simultaneous interpretation is included.

Aelodau'r pwyllgor yn bresennol
Committee members in attendance

Peter Black	Democratiaid Rhyddfrydol Cymru Welsh Liberal Democrats
Christine Chapman	Llafur Labour

Jocelyn Davies	Plaid Cymru (Cadeirydd y Pwyllgor) The Party of Wales (Committee Chair)
Paul Davies	Ceidwadwyr Cymreig Welsh Conservatives
Mike Hedges	Llafur Labour
Ann Jones	Llafur Labour
Julie Morgan	Llafur Labour

Eraill yn bresennol
Others in attendance

Ian Johnson	Cadeirydd Bwrdd Cyllid Cymru ccc Chairman of the Finance Wales plc Board
Sian Lloyd Jones	Prif Weithredwr, Cyllid Cymru Chief Executive, Finance Wales
Christopher Rowlands	Aelod o Fwrdd Cyllid Cymru a Chadeirydd y Pwyllgor Buddsoddi Finance Wales Board Member and Chairman of the Investment Committee
Peter Wright	Cyfarwyddwr Buddsoddi Strategol, Cyllid Cymru Strategic Investment Director, Finance Wales

Swyddogion Cynulliad Cenedlaethol Cymru yn bresennol
National Assembly for Wales officials in attendance

Richard Bettley	Y Gwasanaeth Ymchwil Research Service
Claire Griffiths	Dirprwy Glerc Deputy Clerk
Meriel Singleton	Ail Glerc Second Clerk

Dechreuodd y cyfarfod am 09:29.
The meeting began at 09:29.

Cyflwyniadau, Ymddiheuriadau a Dirprwyon
Introductions, Apologies and Substitutions

[1] **Jocelyn Davies:** Welcome, everyone, to this meeting of the Assembly’s Finance Committee. Can you just check, if you have a mobile phone with you, that it is switched off, because not only is it very embarrassing for you if it goes off, but it can interfere with the broadcasting equipment? I have had one apology from Alun Ffred Jones.

9:30

Papurau i’w Nodi
Papers to Note

[2] **Jocelyn Davies:** Before we move to the next item on the agenda, are Members happy to note the minutes of the last meeting and the additional information that the Federation of Small Businesses very kindly sent us? I see that you are happy.

Ymchwiliad i Cyllid Cymru: Sesiwn Dystiolaeth 4
Finance Wales Inquiry: Evidence Session 4

[3] **Jocelyn Davies:** Moving on to our first substantive item on the agenda, which is our inquiry into Finance Wales, we have an evidence session today. We have representatives from Finance Wales with us this morning. Would you like to introduce yourselves for the record? We will then go straight to questions, if that is okay.

[4] **Mr Rowlands:** Good morning. I am Christopher Rowlands. I am an independent director on the board of Finance Wales. I have 35 years' experience of financing small and medium-sized enterprises in Wales and the UK. I led a review for the UK Government on access to finance for SMEs and, last year, supported Tim Breedon in his review of access to debt finance for SMEs.

[5] **Jocelyn Davies:** Thank you.

[6] **Mr Johnson:** I am Ian Johnson. I am the chairman of Finance Wales. I have been a professional director for 25 years and chairman of a number of other public companies.

[7] **Jocelyn Davies:** How long have you been the chairman of Finance Wales?

[8] **Mr Johnson:** Since 2008.

[9] **Jocelyn Davies:** Okay.

[10] **Ms Jones:** I am Sian Lloyd Jones. I have been the chief executive of Finance Wales since 2004—nearly 10 years.

[11] **Mr Wright:** I am Peter Wright. I am the strategic investment director of Finance Wales. I have been at Finance Wales for just a year less than Sian and I slightly trump Chris as I have been in financial services for 40 years, I am afraid—

[12] **Jocelyn Davies:** Have you? [*Laughter.*]

[13] **Mr Wright:** I think that I was 11 when I started.

[14] **Jocelyn Davies:** Yes, you must have been very young. If it is okay with you, we will go straight to questions. Obviously, you sent us a number of documents—information and written evidence—that Members will have read. It was very comprehensive, and we are very grateful for the note on the Eversheds document on state aid. We have also received your response to the review. Of course, our inquiry is not connected to the Welsh Government's review. We are doing our own inquiry. For the record, would you like to briefly summarise the main purposes and key objectives of Finance Wales? Who would like to do that?

[15] **Mr Johnson:** Shall I do that? The role and remit of Finance Wales is embodied in the management arrangement that has been in place since 2006, since the transfer from the Welsh Development Agency. It might be helpful, Chair, if I read to you the paragraph that embodies that role:

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

[17] That is our role and remit, which we consider we have stuck to rigidly.

[18] **Jocelyn Davies:** Okay. What was the background for the creation of Finance Wales in 2001?

[19] **Mr Johnson:** Maybe Sian knows.

[20] **Jocelyn Davies:** Was anybody around at the time?

[21] **Ms Jones:** None of us were actually around at the time. I think that it goes back to 1999, actually. It was a joint policy initiative between the Welsh Government of the day, the Confederation of British Industry and the Federation of Small Businesses, partly in response to the withdrawal of people like 3i from Wales and the fact that there was a gap in the market in terms of funding for SMEs. It was part of a wider UK initiative. There was something called the Objective 1 alliance, so similar initiatives were carried out in Merseyside, Yorkshire and Cornwall at the same time, and there was a united bid, as it were, to the European Commission for European regional development fund money, for the first suite of funds, from the Objective 1 funds. In those days, of course, partnership was very much a key theme. This was before my time, but the board comprised representatives on a third-third-third basis from the public, private and voluntary sectors. It was chaired by somebody called Brian Howes, who was an industrialist.

[22] **Jocelyn Davies:** Okay, thank you. How have your current objectives been set?

[23] **Mr Johnson:** The board sets the objectives in consultation with the Welsh Government and the Minister and we provide the Welsh Government with a business plan annually, which is signed off by the Minister and her officials, and sets the plan for the coming year. We also provide a three-year long cast of our strategy.

[24] **Jocelyn Davies:** Have those objectives changed since the creation of Finance Wales?

[25] **Ms Jones:** The underlying remit has not changed at all in its provision of commercial finance to small and medium-sized enterprises. Even in the early days—again, before my time—it was viewed as a development bank, and that was one of the challenges that it faced in terms of the expectations that were placed upon it by the different stakeholders. So, on the one hand, you had the commercial investors, Barclays, expecting us to return the borrowings to them; and, on the other hand, you had businesses and communities that thought that, as this was a publicly owned and partly publicly financed operation, it should be providing subsidised finance. So, when I arrived in 2004, it was failing on every metric; it was not satisfying any of the stakeholders; it was not performing from an investment point of view; and it was in breach of its bank covenant. So, it was a very difficult birth for the organisation, if I can put it like that, with that weight of expectation and that breadth of expectation. Peter was actually on the board at the time, so he can probably offer a view.

[26] **Jocelyn Davies:** I see. Were you on the original board?

[27] **Mr Wright:** Yes. I am not sure which third I was in, but I was definitely in the private sector third. At the time—as Sian was saying—it was certainly set up to access the European structural funds and particularly to deal with Barclays, which was the principal backer of all of those funds around the UK. Certainly, as a non-executive, and from what I saw of the board—I was living and working in London then—it did as Sian said: there was that balance where you have a private investor, effectively, in the form of Barclays, which

was looking for a commercial return et cetera, and under the terms of European structural funds, there was the same requirement, but also the relative key performance indicators around job creation and economic development. I think that it has always been seen, certainly at the same time across the UK, that most of the funds that Sian mentioned were all facing a similar challenge because you have to repay the bank first under the terms of the agreement. Therefore, there are covenants, as Sian also touched upon, so that is one of the drivers.

[28] I would like to think that Finance Wales has demonstrated since that you can balance the two. It is when you try to give the two of them at the same time that you get into difficulty. I think that our view has been that the principle that is enshrined within the ERDF is that you should be a commercial investor. On that basis, if you are making a good commercial sustainable investment, the growth, the jobs and all of the economics will flow from that as a matter of course. If you are making a bad investment into a poor company, the survival of that company will probably be in question.

[29] **Jocelyn Davies:** Is that any different from any commercial bank?

[30] **Ms Jones:** Oh, yes.

[31] **Mr Wright:** Yes. A commercial bank, in particular, expects absolutely a commercial return all of the way through on all of its money. One of the benefits of having access to structural funds is that there is no cost of capital that comes with that in the same way as, clearly, borrowing. That, quite explicitly, is there to enable, and the Commission indeed requires that you actually try to reach the parts of the economy where you are operating, particularly in the assisted areas that do not get support.

[32] **Jocelyn Davies:** If there was a sort of confusion because of different expectations, was there any confusion about the objectives?

[33] **Mr Wright:** Not from my position on the board; I did not feel that.

[34] **Jocelyn Davies:** I think that Peter wanted to come in on this.

[35] **Peter Black:** I just realised that my question—[*Inaudible.*]

[36] **Jocelyn Davies:** You are leaving it. Okay. I will therefore turn to the current situation. Could you briefly summarise the current supply and demand for lending between banks and SMEs? Is there a market failure?

[37] **Mr Wright:** I would say, ‘absolutely’, Chair, and it is much more noticeable, obviously, since 2008, when what is now called the banking crisis came about. Prior to that time, there was some supply, and probably some parties would say that there was an excess of supply and that the banks did too much, particularly in certain sectors of the economy, with property being one example. Here we are now, five to six years on from that, and the banks very clearly, for understandable reasons in terms of having to, basically, put right their own balance sheets—where they have taken big provisions not only from poor lending, but also from various misselling exercises—have curtailed a lot of their investing into what they see as higher risk areas. So, there are some sectors, like property and, in some cases, leisure and tourism, that a lot of them have off limits. However, they are only doing secured lending, on the basis that that actually requires less capital, which is one of the key issues that they are facing going forward, because of changes in the regulatory capital requirements that have been imposed on all the banks.

[38] **Ms Jones:** I would say that the gap is greater now than it was when Finance Wales was originally established. At that time, the cap that was put on the gap—if I can call it that—

was circa £1 million, so that, above that level, people should be able to access finance from traditional commercial sources. By the time that we did the research to underpin the JEREMIE fund, which was launched in 2009, but we did that research in 2007-08, it was felt that the gap had grown to £2 million. That was the basis on which we secured a state aid notification, so that we could invest up to £2 million in a single round in a particular company. Of course, the banking crisis followed that, and we saw a massive upsurge in demand for finance from Finance Wales from companies that previously would have been able to get funding from traditional sectors.

[39] **Jocelyn Davies:** So, does Finance Wales meet that gap?

[40] **Ms Jones:** I think that we meet a large part of the gap for businesses that do not have security and that do not have a banking track record. There is no such thing as a perfect investment that comes to us—they are not absolutely ready, and we have to do a lot of work to get businesses investment-ready.

[41] **Mr Rowlands:** We also assist companies that suddenly find themselves in sectors that are completely out of favour with the principal sources of clearing bank debt. So, right up to current times, at investment committee, we frequently see situations where the banks declare, on a local basis, that if only they were able to, they would, but policy across their organisation dictates that they cannot. As Peter said, I think that that is particularly prevalent in areas like construction and property, where I would say that that is current market failure, as a sector, and we are providing a service to attempt to fill that gap locally.

[42] **Ms Jones:** Also, the gaps change, in terms of the nature of the financial provision. So, based on our experiences elsewhere—and we have seen it in Wales as well—there is a gap for what we have described as a working capital fund, which was not something that was in evidence in 2007-08, when we secured the JEREMIE fund. So, that is something that Peter and the team have been working on with the Welsh Government, putting something together to fill that gap, which has emerged as a result of changing policies and practices in the wider financial services sectors. So, I think that that is an important function for us, in a sense—not just to stick to the original knitting, as it were, but to sort of keep our eyes and ears open to what difficulties companies are facing in funding different types of activity.

[43] **Mr Rowlands:** It is a critical element at times of, dare I say, economic recovery—fingers crossed—because as local Welsh SMEs start to win export contracts, perhaps in new territories for them, their ability to go and finance that contract is nigh on impossible, because they do not really have any sort of security to offer a bank at that stage, and so they are coming to us to finance specific contracts that will mean a substantial growth in those businesses. We saw one at the investment committee this week, which will be fantastic for that company, and obviously great for Wales, because it is a huge, expansive project. That one happens to be UK-based, rather than export, but the principle is the same.

[44] **Jocelyn Davies:** Ann, shall we come to your questions?

[45] **Ann Jones:** Could you just briefly summarise the governance arrangements of Finance Wales, and then how you report and liaise with the Welsh Government and the Ministers?

[46] **Mr Johnson:** As a public limited company, we are heavily governed. We have internal auditors and external auditors. We are also reviewed by our funders, the likes of the banks and the European Investment Bank. So, externally, there is a great deal of governance of the organisation. We have a board of independent directors, and a senior independent director is here today—Chris.

09:45

[47] We set up a number of committees that look after various elements of the company. We have an audit committee, a remuneration committee, a nominations committee, a risk committee, and so on. So, a number of committees look at various aspects of the running of the business and report to the main board.

[48] In terms of our relationship with the Welsh Government, as I mentioned earlier, we report full accounts annually, and I hold very regular meetings with the Minister. We discuss how the organisation is doing, but also ways in which we might improve our service and offering to Welsh SMEs. Would anyone like to add anything?

[49] **Ms Jones:** We have a Welsh Government observer on the board and also at the audit committee. As Ian has mentioned, there are regular meetings with the Minister, but also with officials. At the moment, we are meeting more or less on a fortnightly basis, because it is that time of year—the end of the financial year and the beginning of the next one. That is at the more strategic business planning level. On a day-to-day basis, different teams within the organisation are interacting locally with different teams within the Welsh Government. For example, the principal relationship of the microbusiness team with the Welsh Government would be through Business Wales, whereas the technology ventures team, which invests in very early stage intellectual-property-rich companies, will be liaising with the innovation teams within the Welsh Government. So, there is quite a matrix of different relationships on a day-to-day basis.

[50] **Ann Jones:** How have the reporting arrangements with the Welsh Government changed since the abolition of the Welsh Development Agency?

[51] **Ms Jones:** They are more direct, in the sense that, previously, Finance Wales's reporting arrangements were through the WDA board and then into the Welsh Government. I think that that is viewed as a benefit. It certainly has not presented any difficulties from our perspective. It is also viewed as a benefit when we are dealing with organisations such as the European Investment Bank on negotiating funds for the JEREMIE scheme. It was a much more direct route than what they were experiencing in England, where they were dealing with local regional development agencies and were then having to go through the Department for Business, Innovation and Skills and the Department for Local Government and Communities before they finally got to an answer. So, I think that the arrangements are more direct.

[52] The governance arrangements set out in the management arrangement means that we will report quarterly on each of the individual funds to the department for the economy and to the Welsh European Funding Office. They have access to the information whenever they need it.

[53] **Mr Johnson:** To come back to your initial question, we also liaise with the Welsh Government corporate governance committee, and we provide copies of our audit committee meetings routinely to it. We are also highly regulated by the Financial Conduct Authority, as it is now, as are some of our subsidiaries. We also have to comply with Office of Fair Trading regulations in terms of credit licences, and so on.

[54] **Ann Jones:** Have the policy objectives of the Welsh Government that are conveyed to Finance Wales changed over the time that it has been operating?

[55] **Ms Jones:** Yes. The priorities within the overriding economic development policy might have changed. For example, the approach to sectors by the Welsh Government is a comparatively recent development, as are the enterprise zones. When things like that emerge, we look to see in which ways we can support them. If we take sectors as an example, we have

designated a sector lead internally from within Finance Wales to liaise with sector teams and sector panels in the Welsh Government. The overriding priorities of jobs and growth have not fundamentally changed that much in the last 10 years, in my view. How you achieve it may have changed.

[56] **Jocelyn Davies:** So, you would respond to policy initiatives, but the overall objectives—

[57] **Ms Jones:** Yes.

[58] **Christine Chapman:** On the various approaches, I know that you have been there with a number of different Ministers, so each new Minister will come in with a slightly different approach. Is that reflected in the engagement that you have and the clarification that you as an organisation do?

[59] **Ms Jones:** If we speak about the current arrangements and the current Minister, it is reflected in our approach and also in some of the funds that we have to deliver. For example, the Minister established the microbusiness task and finish group a few years ago, and one of the recommendations from that was the creation of a microbusiness loan. Up until that time, we had a small microloan scheme within the JEREMIE fund, which was targeted at business to business and not business to consumer. So, we were not able to fund retail projects, small-scale leisure and personal services and that kind of thing. As a consequence of that review, the Minister chose to fund a microbusiness loan, and that has been operating within Finance Wales since April of last year. Similarly, there are projects in the tourism and leisure sector that we could not fund through JEREMIE and the Minister, again, made money available for the SME fund. More recently, we proposed the property fund, in response to a gap in the market for small-scale developments. That has only been operating for 12 months, but it is delivering on the funding gap and on some economic and social objectives.

[60] **Peter Black:** In the last session, when the Federation of Small Businesses gave evidence to us, it was very keen to see a development bank for Wales in place. Do you consider yourselves to be a development bank? To what extent do you liaise with start-ups to help them?

[61] **Mr Rowlands:** I think that we have to be careful when we use the word ‘bank’, for a variety of challenging reasons. I think that we are certainly a development finance organisation. ‘Bank’ has some pretty draconian baggage that comes with it, not least capital rules and all the rest of it. So, in a technical sense, no.

[62] **Peter Black:** You are a development organisation.

[63] **Mr Rowlands:** Yes. I was not being pedantic; I think that it is a big issue, particularly in terms of some of the suggestions regarding how things might develop in the future. So, we are definitely a development finance organisation, as has been said already, combining economic development, business growth and job creation and retention, through the provision of finance into sustainable businesses, which leads to sustainable jobs. We finance start-ups as well as young growing businesses. We reviewed, just yesterday, a fantastic array of start-up businesses in, particularly, the technology area. Twelve of those businesses were not in Wales, and as a direct consequence of Finance Wales’s intervention, those 12 business have been moved—lock, stock and proverbial—to Wales, from Oxford, Cambridge, south-east England and all over the place, which I think is a great demonstration of our raison d'être, if I can put it that way. So, I think that we are a functioning development finance organisation, for sure.

[64] **Mr Johnson:** Over the years, we have developed business support, which is linked

with this call for a development bank, very carefully, particularly in the start-up situation, where we put in place mentors and non-executive directors to get the business going properly, alongside continuing investment in those businesses. So, there is a large element of business support inherent in our investment business.

[65] **Peter Black:** How much of your business is with start-ups? What is the proportion?

[66] **Mr Wright:** I would say, in terms of numbers of businesses supported, we sent through some data showing the average loan size, and you will see that there is a large number—I think that it was 155—in the micro market. We define the micro market, following the European definition, as being companies or businesses employing between 0 and 10 people, which, actually, is a large part of the SME population in Wales. Almost 90% of it is in that market. In terms of the amounts required, I recall reading a transcript in which the FSB representative acknowledged that its typical client would probably not be borrowing more than £15,000.

[67] The other thing, in terms of the start-up end of the market, is that what is not often recognised, although Professor Dylan Jones-Evans mentioned it in his report, is the SME Finance Monitor, which is one of the biggest surveys. There is a question of people who are classified in that as permanent or contented non-borrowers, in the sense that they have no intention of borrowing. You tend to see that more in owner-managed businesses—the very small businesses. Discussions have emerged in this committee about how, sometimes, those businesses use their own credit cards. However, you are the business; if you are a hairdresser, a taxi driver, or a plumber, it is your business and your personal finance is almost inextricably linked into it. Often, the individual will have remortgaged their house to put money in in the first place. A lot of those businesses, and certainly the SME Finance Monitor suggests that at least a third of all SMEs and possibly as many as 50% in the very small businesses, will do that. Often, there is a large contingent that would not necessarily want to borrow externally, other than from friends and family, or whatever.

[68] **Jocelyn Davies:** That was a lovely answer, but what Peter asked you was how many of your businesses were start-ups.

[69] **Peter Black:** What sort of proportion—

[70] **Mr Wright:** I am sorry, I meant earlier on; the numbers—

[71] **Jocelyn Davies:** Yes, but you were talking about SMEs.

[72] **Mr Wright:** I see. Of the 270 that were showing on that, say 155 of them, so pretty much half were—

[73] **Jocelyn Davies:** About half were start-ups.

[74] **Mr Wright:** Yes.

[75] **Peter Black:** Would you say that the failure rate of the start-ups that you work with is any different to a bank for anybody else, for example, given the business support that you offer to them?

[76] **Mr Wright:** I do not think so. It is higher only in the sense that banks will always only lend secured. So, if a business does fail, there is a likelihood that the bank will look to their security from that point of view. Ours are always unsecured, but for the underlying business, the same principle applies.

[77] **Peter Black:** So, the failure rate for start-ups is not much different with you than if they had gone down a different route of financing.

[78] **Mr Wright:** No. I would say not.

[79] **Ms Jones:** Except that they probably would not have been able to get finance from another source; that is the point.

[80] **Mike Hedges:** Just for clarification, we have been told by other people that you have secured loans; are you saying that they are all unsecured?

[81] **Mr Wright:** We will take security if it is available, particularly if it is a limited company. The security that we normally take is called a mortgage debenture, which is a general charge across the company's assets. What we invariably find, however, is that the bank is the first lender to those businesses and, therefore, it has the first charge; ours is, if you like, a second charge. We take it as security, but we are rarely able—in fact, we never are—to attribute any value to that at all.

[82] **Mr Rowlands:** As an investment committee, I would say that 90% of what we look at is unsecured, in the sense of any asset cover available for our lending. Even if we technically have a debenture behind the bank—so technically, we have a security document—its value is zero. So, we are in—

[83] **Jocelyn Davies:** The bank has had first dibs on anything that is worth anything.

[84] **Mr Rowlands:** That is correct. You are absolutely right.

[85] **Jocelyn Davies:** You said that it is secured on the business's assets. A lot of the people we speak to imagine that their house is not part of the business, but they have had to put that up to the bank in order to secure a loan. You do not do that, do you?

[86] **Mr Wright:** No.

[87] **Jocelyn Davies:** You do not secure a loan to a business on a person's personal assets.

[88] **Mr Wright:** No. We would take a personal guarantee to tie them in from that point of view. That would be limited to a sensible amount. However, in terms of taking second, or even third, mortgages over people's property, no.

[89] **Jocelyn Davies:** Mike, is that okay? Ann, shall we go back to your question?

[90] **Ann Jones:** Yes, I will move on. Do you believe that enough information on your organisation is publicly available? I know that there are some commercial restrictions—

[91] **Jocelyn Davies:** We know that you have been in the headlines recently, but—[*Laughter.*]

[92] **Mr Johnson:** I think that the short answer is that, clearly, we recognise that we need to do more in terms of stakeholder communications. There is clearly a gap in knowledge out there in some quarters, which we are addressing, but, as we said earlier, the publications are there and are available as public documents for everyone to see.

[93] **Jocelyn Davies:** However, you would have to look for it to get it.

[94] **Mr Johnson:** That is an area that we need to address.

[95] **Ann Jones:** Will you look to publish a more accessible full annual report, and put it on your website? Will it be easily accessible without having to delve through—

[96] **Mr Johnson:** Yes. I think that we need to signpost the documents that we have more effectively.

[97] **Jocelyn Davies:** Julie, did you want to come in on this particular point?

[98] **Julie Morgan:** What has been your reaction to the criticism that there has been, such as that your information is not readily available, and to the fact that, when we interviewed Professor Dylan Jones-Evans, he repeated the 'not-fit-for-purpose' phrase? I just wondered what your reaction was to those comments.

[99] **Jocelyn Davies:** Briefly, because I am sure that you—

[100] **Mr Johnson:** We are all eager to jump in on that one. [*Laughter.*]

[101] **Jocelyn Davies:** Yes. You will have opportunities as we go through the session, but particularly about that point—

10:00

[102] **Mr Rowlands:** If I might start from a point of independence, if that is possible, given that I am on the board, what I find very sad about all of that is that Finance Wales is held in very high regard by quite a number of organisations outside of Wales, such as the Scottish Government and the UK Government. I know that for a fact, because I have been told so directly to my face, given some of the reviews that I have been engaged in for the UK Government. For an organisation that seems to be fulfilling the objectives set by the Welsh Government, it is, as I say, extraordinarily sad that something that is doing something really valuable in the Welsh economy, as a matter of fact, has been subject to such external challenge. We are never above challenge, are we? Of course not, and that is not my point. It would be great to see some support for something that is actually functioning rather well.

[103] **Jocelyn Davies:** Is that okay, Julie?

[104] **Julie Morgan:** May I follow that up?

[105] **Jocelyn Davies:** Yes, go on.

[106] **Julie Morgan:** I understand that Professor Jones-Evans was a member of your board at one time.

[107] **Mr Rowlands:** Yes, he was.

[108] **Mr Johnson:** It was before my time.

[109] **Julie Morgan:** I wondered if—

[110] **Jocelyn Davies:** Was he during your time?

[111] **Ms Jones:** During my time? Yes, and he was a founder member of the board, I believe—

[112] **Mr Wright:** That is correct.

[113] **Ms Jones:** He was on the board up until 2006.

[114] **Jocelyn Davies:** That is quite a long time, then.

[115] **Ms Jones:** I joined in 2004, when he was a board member. Of course, not long after that, the abolition of the WDA was announced—in July 2004—and the focus of the board in 2004-05 and 2005-06 was very much on where Finance Wales was going to end up, because, at that time, it was a wholly owned subsidiary of the WDA. What should its purpose and remit be, assuming that there was going to be a Finance Wales beyond the life of the WDA? So, there were a number of strategic reviews and discussions that took place at that time, which led to the conclusion that the best place for us was to be a wholly owned subsidiary of the Welsh Government. So, he participated fully in that and also, at that time, we had a few programmes around access to capital and investment readiness, and the conclusion of that review, because there was a lot of business support happening in the WDA at the time, was that it would make more sense for those few, small programmes that we were running, not particularly well, to be transferred across to the Welsh Government to be incorporated into the offering from it. A lot of them continue today through Business Wales.

[116] **Julie Morgan:** May I just ask: why did he leave the board?

[117] **Ms Jones:** After the decision was made in November 2005, I believe, for Finance Wales to become a wholly owned subsidiary, we had not had any board changes, because of all the uncertainty, for quite a number of years, so, in consultation with the WDA and the Welsh Government, we decided to recruit new members. They came on board, I believe, in June 2006. So, all the existing board members were able to be considered as part of that process—we used external recruitment consultants—and while that process was going on, Dylan announced that he was standing as a candidate in the Assembly elections, and our board member guidelines prevent you from pursuing political ambitions and being a board member. His contract came to an end—I believe that it was in March, but I cannot be certain—in 2006, so it was not renewed as part of that exercise of refreshing the board.

[118] **Jocelyn Davies:** You had churn within the board. Thank you for that. Ann, shall we come back to you?

[119] **Ann Jones:** Would there be any barriers to the Assembly scrutinising the strategy and annual performance of Finance Wales in the future?

[120] **Ms Jones:** I think that if you look at our management arrangement, specifically in relation to the chief executive, it says that I am subject to being called to appear before any committee of the Assembly—the Public Accounts Committee, the Finance Committee or the Enterprise and Business Committee. The fact is that that has not happened until now. There is nothing to prevent that under the current arrangements.

[121] **Ann Jones:** You do not see any barriers in the future if we suddenly decided that we were going to have a whole day when we brought in Finance Wales and went through your annual—

[122] **Mr Johnson:** I think that we would welcome it.

[123] **Jocelyn Davies:** You all seem very pleased to come to see us today. [*Laughter.*]

[124] **Mr Johnson:** May I come back to a question that you asked earlier and follow up Chris's preliminary comments? We have all been extremely concerned by the effect of the misreporting and misunderstanding of Finance Wales on the organisation. It has caused great

instability, and we really look forward to putting an end to that so that we can move on constructively.

[125] **Jocelyn Davies:** Our committee brings light as well as heat, so you will be pleased that you have had this opportunity. Paul, shall we come to your questions?

[126] **Paul Davies:** Thanks, Chair. I just want to ask you some questions regarding your policies on lending. You have made it absolutely clear this morning that, as an organisation, you are there to fill a gap in the market. Can you tell us what proportion of your business actually goes towards supporting SMEs that have been turned down by traditional banks?

[127] **Ms Jones:** On the application form, they will declare that they have not been able to source the funds from anywhere else, but, in reality, we do co-invest alongside the banks as well.

[128] **Mr Wright:** One of the requirements of having European funding is that you should not displace the private sector—that is, the banks—in any way. That is why that is written into the application form. As Sian says, the banks, since the crash, are probably our biggest introducer of business. They quite often pass business directly to us that they cannot do, because, from their perspective, there is a commercial self-interest. We are agnostic as to where the SME banks, whereas if they refer something to us, it means that they are maintaining their ongoing banking relationship, or whatever. We do not keep statistics directly on that. We take the view that it is signed off by the applicant that they have tried to get to the bank. We know, from the general comments that we touched on earlier, about the difficulties that we see with banks being able to provide support anyway.

[129] **Paul Davies:** So, you do not have actual data on that.

[130] **Mr Wright:** Not directly. We track where we get referrals from, and so we can track by bank, and we even run a league table to some extent to see who is referring most, and unsurprisingly it is Barclays and Lloyds, which have the two biggest markets among the Welsh SME banks.

[131] **Paul Davies:** Could you summarise for us the proportion of your investments that were actually made through loans, equity or, indeed, other arrangements?

[132] **Mr Wright:** Certainly. The funds that we have we construct usually so that, typically, I would say, 40% to 50% is in loans, and that also reflects current changes, I would say. That includes all loans, from the microloans that we touched on earlier. Typically, I would say, assuming that is around 50%, that about 30% of it goes into equity. That picks up the point that, I think, Chris made about a lot of that goes into technology investing, and there is a fairly large part of that. That is usually for start-up businesses, or businesses at a very early stage, so they certainly have not yet made any revenues et cetera from that point of view. The balance probably is what we would call mezzanine, which sits between debt and equity anyway, where it would be deemed a higher risk—the ability of the business to repay probably requires some growth to be achieved. So, it is not immediately—it can do it from its existing profitability, and that, if you like, is around mezzanine. So, that actually has been growing because the reality is that, in most SMEs, they do not like giving up equity, which is understandable. Therefore, I would say that the established businesses that might be looking for growth capital always look for debt, or will take mezzanine if that is the only other solution that is on offer. We quite often do a mix of both.

[133] **Ms Jones:** It does vary according to the fund as well, so, for example, the microbusiness loan fund, which is a £6 million fund in total, is entirely loans—there is no mezzanine or equity in that. I was talking largely about the JEREMIE fund, which is split in

that way, which is the £150 million fund.

[134] **Paul Davies:** What is the typical return on capital that you seek from the different types of investment?

[135] **Mr Wright:** Certainly, on the debt return, typically we would look at pricing that in terms of the debt return, and that, on a gross basis, is usually between 7% and 12% on a net basis. That would be either gross or the interest rate that we would typically be charging, and most of our interest rates, on average, are probably coming out at around 10%, I would say. On a mezzanine, you would be looking for a mid-teens sort of price, and that is traditionally where you would be looking—from 12% up to 18%—that sort of level. Again, these are gross returns, before costs or whatever. On equity, the traditional view is that you should be looking at a 30% return for equity. You do not always get it, of course, because it is the nature of the risk there, but that would be the way that you would typically price the returns overall. That has been fairly consistent, I would say, Chris, for a long period of time. They reflect the different risk profiles.

[136] **Paul Davies:** You have made it clear that 40% to 50% of your business is lending to smaller businesses. What percentage of those loans to small businesses do you expect to default?

[137] **Mr Wright:** We model them in our funds when we go to raise the capital in the first place. Typically, we expect to see our loan book defaulting at around 10%. It is actually 9.1% at the moment. We can tolerate defaults up to 20% before we run into problems with our banking partners. They have covenants set at that level, which allows them, if necessary, to step in.

[138] **Jocelyn Davies:** Last year, it was 10%. What does that mean?

[139] **Mr Wright:** That would mean one in 10 of businesses—

[140] **Jocelyn Davies:** Do you know how much money that would be in a year? Could you send us a note?

[141] **Mr Wright:** Yes, for sure; absolutely.

[142] **Paul Davies:** What are the main reasons you give for rejecting a loan to a small business?

[143] **Mr Wright:** It is usually captured under the generic heading of viability. Often, it is about—and I should preface this by saying that, typically, we turn down between 33% and 35% of the applicants that come to us—not being as convinced about the market opportunities; what their product or service is and what it is seeking to target. That is usually the biggest area we look at. Also, have they properly assessed the competitive position? If they are going to set up a coffee shop somewhere, we find quite often that the assumption is—particularly among smaller businesses—that they are the only people doing their particular thing, when the reality is there are often others. The second largest thing, which is the more difficult one, is: are we absolutely convinced that the management team can pull off that business plan? Have they got the track record? Are they going into a new area? Can we help them by adding to the management team and working with them? In many cases, one of the first things we do is to try to make sure that there is a really good finance director involved in the business who can produce regular figures so that we, and the company, can assess how well they are doing. That is a fairly common weakness. I would say that it is more about whether they can find a market.

[144] **Ms Jones:** The other point, Peter, is whether they can service the debt. We are largely lending unsecured, so the cash flow is the important thing. Can they meet the repayment schedules? That is a key factor in determining whether to say 'yes' or 'no'. It depends on the size of the business and the quantum of the investment. That is fairly critical.

[145] **Paul Davies:** What is the most common type of criticism you receive from small businesses that have been turned down for a loan?

[146] **Mr Wright:** I would say that the most common one is probably that we have taken too long to get to the decision point. We aspire to turn things around quickly enough, but, as Ian touched on earlier, we are looking at our communications. One of the things we have running at the moment is a series of teams within the organisation, which we have had running since autumn, to look at how we can speed up that process.

[147] **Jocelyn Davies:** How long does it normally take?

[148] **Mr Wright:** It varies. Generally, we aim to turn around microloans at the smaller end, because they are more straightforward, in 10 days. Generally, we do.

[149] **Jocelyn Davies:** People say that is too long, do they?

[150] **Mr Wright:** One of the things is that it depends on when you set the clock running. In terms of whether we have all the information, we may have to go back and say, 'We need this as well' and 'Can we see your bank statements?' There is some information that comes with the application.

[151] **Jocelyn Davies:** So, you accept that perhaps it is a bit longer than people would like, and you are trying to—

[152] **Mr Wright:** I would like to see it done faster. There are opportunities to improve our online assessments and the way in which we take applications. They invariably come in with an application form in the traditional paper format. I am interviewing this afternoon, with our IT specialists, some people who can hopefully help us design a platform that will improve our online offering.

10:15

[153] **Ms Jones:** The last time we did a customer perception survey of Finance Wales, bureaucracy was one of the things that came back as a criticism. That is a benefit and a curse, in a sense, because other investors who invest alongside us value the diligence we undertake before we make an investment decision, and they place quite a lot of reliance on that. So, that is something that we are acutely aware of—it is very easy to slip into doing things in a particular way without keeping an eye on turnaround times. We are very conscious of it.

[154] The other thing that people sometimes do not understand is that, if they have been supported, let us say, by the Welsh Government with a grant, and yet we have turned them down for a loan or an equity investment, they do not understand why a wholly owned subsidiary of the Welsh Government might have a different view on viability. Often, that is about where the business is with regard to the stage of its evolution, rather than any fundamental difference of opinion about the potential in the longer term.

[155] **Jocelyn Davies:** Mike, shall we move on to your questions?

[156] **Mike Hedges:** I want to talk about interest rates, and I will also refer to the Finance Wales interest rate review, which I am sure you know far more about than I do. The first

question, which is one I have asked to other people, is: are your interest rates based on the level of difficulty or risk? Do you vary them according to risk?

[157] **Mr Rowlands:** Yes, absolutely.

[158] **Mike Hedges:** We have had evidence that suggests that you should really be offering much lower interest rates. I said at that time that, if you were not making a very large profit on the interest rates at which you are lending you, that is, if you offered very low interest rates, you would run out of money very quickly. Do you agree with me on that?

[159] **Mr Rowlands:** Yes. [*Laughter.*]

[160] **Mike Hedges:** We are doing very well here.

[161] **Jocelyn Davies:** You might find Mike on your board. [*Laughter*.]

[162] **Mike Hedges:** The review also stated that, in 23% of cases, Finance Wales was charging rates that were deemed to be above the market rate. Why?

[163] **Mr Rowlands:** That is primarily because of our assessment of risk. Once you get into that risk territory, one organisation's judgment will not be completely in synchronisation with another's. So, it is just our view of that risk. As you rightly say, our role is to make sure that there is the potential for sufficient interest return for us to continue to reinvest in small and medium-sized enterprises in the future. So, if we underprice risk, then it is a path to nowhere.

[164] The Breedon review coined a fantastic phrase, looking back a few years, which was that the country, including Wales, had gone through a period of lazy borrowing and lazy lending. That is absolutely right. Risk was mispriced and underpriced. If you were to underprice risk, you have to ask whether you are doing that business a service, in the sense that it will assume that its capability of servicing borrowing is a false premise.

[165] **Mike Hedges:** If you were to offer reduced interest rates, you would have to reject more applications. You would have to reject the higher risk items.

[166] **Mr Wright:** Yes. There is a correlation here that ties in with the question that I was asked about default rates. We are losing, as I said, about 10% of the business, whereas a bank would be seriously worried if it had a failure rate of more than 1%. Santander has told us that its rate is 0.6%. So, with regard to reducing the interest rates, in part, the pricing reflects that risk, so if the interest rate was going to be capped at 5% or something like that, we would then almost have to make sure that our default rates probably came down to 5%, which would mean that we would need to be more selective.

[167] **Jocelyn Davies:** On this point, there has been a review of Finance Wales's interest rates—and we have that information from your website—and Mike just mentioned that 23% of your lending was deemed to be above the market rate, which you have said is because of risk. However, the review goes on to say that these tended to be in relation to lower risk deals.

[168] **Mr Wright:** Yes, I believe that it looked at a couple of property deals. The person doing the review was a commercial asset broker and therefore would be used to placing these either on funding circle, or one of the online platforms, or with other asset finances. The position there, often, is that asset financiers are generally specialists in certain assets. The question we would have asked that individual—not knowing where the rates were; we priced it for the risk as we saw it—would presumably have been: 'Have you tried to access that finance from one of those providers already?' As we said, that is one of the questions that we ask them when they are provided. Generally, one assumes that—. The individual who did the

review is clearly very experienced, but that may well have been the case. An asset broker—like any broker—will go to probably four or five different places, whereas, often, an SME may only go to one.

[169] **Mr Rowlands:** Peter, I think it is fair to say that the market failure we are addressing is supply; it is the provision of debt and equity capital, and it is not about its cost. So, we do not get companies coming to us and saying, 'We have six offers, can you do it a bit cheaper for us?' We have companies coming to us all of the time—nigh on 100% of the time—saying, 'We can't get this particular period of growth, this particular contract', or whatever it might be, 'financed from traditional sources. Can you help us?' So, it is an access-to-capital issue; it is not a cost-of-capital issue—within boundaries, clearly.

[170] **Jocelyn Davies:** Mike is next.

[171] **Mr Johnson:** May I pick up on something that was mentioned earlier about profit? We do not make profits.

[172] **Mike Hedges:** I know. That was the point I was trying to make.

[173] **Mr Johnson:** What we do is put that money back into the funds. We pay the banks and then the residue is there to invest in SMEs in the future. So, if we did not make the interest rates, we would have less money to invest into future SMEs, et cetera. There is a cost to lowering the interest rates.

[174] **Mike Hedges:** I have two questions. How many companies reject you at loan-offer stage because your interest rates are too high?

[175] **Mr Wright:** We track data on that. I was given the latest figures at the end of last week, and I have brought them with me. It is typically about—. We have what we call a drop-off rate of around 25% to 30% of businesses that decide not to proceed. Now, we ask them, quite often, why and, generally, from the data that I have seen, it is only about 5% to 10% that refer to the cost of finance as being the reason. Sometimes, it may be the other terms. Sometimes people are looking for longer term loans than we are able to supply, because ours are limited to five years and sometimes the business would need a 10-year loan or whatever it might be. However, we do try to track that. We are dependent, obviously—. Some people do not respond to that, you do not hear from them and you just assume that they have decided not to go ahead at all. We have seen a lot of that recently with the general lack of business confidence about the future. People sort of pluck up courage and decide that they are going to ask for the finance and do it, and then, when they have it, often do not necessarily proceed with that particular investment in a new bit of kit or whatever it might be.

[176] **Mike Hedges:** This is my last question. The access to finance review concluded that the interest rates offered by Finance Wales were higher than European Union reference rates when adjusted for risk. How do you respond to that finding?

[177] **Mr Wright:** I think that it goes back to something we touched on earlier, which is the question of the security available in collateral. The work that was done in the access to finance review assumed very much that we were—to use the European term—fully collateralised, that is, that we had 100% security or 50% plus security. The reference rates have a much higher rate where there is less than 50% collateral, as they call it. It goes back to the question that we touched on earlier: is it secured, that is, is there a piece of security? As Chris and I both mentioned, there might be a piece of security, but if it has no value then we cannot ascribe a collateral value to it. So, it might be treated as secure under a very pure definition—which is, I suspect, the view that was taken—but we have to look at it and ask, 'What value is there in it?', and, if there is no value in it, then it is a higher risk transaction

and attracts a higher rate of interest.

[178] **Jocelyn Davies:** Peter, shall we come to your questions?

[179] **Peter Black:** Following on from that, in terms of what you have told us today, you are, effectively, using European structural funds through the JEREMIE funds. As a result of that, your capital costs are much lower than those of a traditional lending institution, yet you are charging high interest rates—or, rather, you are charging interest rates on a commercial basis calculated against risk. So, in that sense, you are, effectively, operating as if you did not have those funds, and as a commercial organisation in a sense. I think the point about the EU reference rate is that, effectively, because you had those European funds, and you did not have that capital cost, you should really be operating with lower interest rates than you are at the moment. Do you think that that is a fair criticism?

[180] **Mr Rowlands:** Well, our interest rate review demonstrates that well over 70% of our loans are at below-market rates of interest. So, I think that the tendency is in the right place and in the right direction. I think that there is then a debate about, frankly, how low should they be to stimulate activity, et cetera. However, it is not the case that we are, despite our cost of money, as you correctly put it, way above market norm—it is the reverse. So, it is reflected in our interest rates to customers.

[181] **Peter Black:** Clearly, you are not a charity, but you are a wholly owned subsidiary of the Welsh Government.

[182] **Mr Rowlands:** Absolutely.

[183] **Peter Black:** You have access to substantial European funds, which gives you an advantage over other lending institutions, and, as a result of that, you are asked to do things that other lending institutions will not do.

[184] **Mr Rowlands:** Yes.

[185] **Peter Black:** With regard to those 30% of loans that are above the average, do you think that that is justified?

[186] **Mr Rowlands:** I think that it is justified within the current objectives to which we comply. If there was a change in strategy from the Welsh Government vis-à-vis interest rates, then, clearly, we would follow it and comply with it.

[187] **Peter Black:** Which specific objectives would those be?

[188] **Mr Rowlands:** That we are in existence to provide investment on a commercial basis.

[189] **Mr Johnson:** And on a sustainable basis. May I pick up also on something else that you mentioned, which was that it gives us a competitive advantage? We do not, and are not meant to, compete with the banks.

[190] **Peter Black:** I understand that.

[191] **Mr Johnson:** So, if we had a zero interest rate, it would not make any difference.

[192] **Ms Jones:** Well, it would, because we would be undercutting them.

[193] **Mr Johnson:** We would be undercutting, yes, but it would not make a difference—

[194] **Peter Black:** No-one is arguing that you should undercut the banks, but I think that the argument is that, in 30% of your loans, you are charging above what other similar institutions elsewhere in Europe would charge in those circumstances.

[195] **Mr Johnson:** May I just make a general comment about interest rates? Rarely, if at all, do businesses fail because of interest rates—it is because the business plan was not good enough, or because of competition, or because the management was not very good.

[196] **Peter Black:** I understand that, but the point is that comparable organisations in Europe are not charging interest rates at the level that you are, so why are you the exception?

[197] **Mr Johnson:** Well, as Chris said, our remit is to provide commercial funds and sustainable funds. If we did not charge those at our default rates—and we write off considerable amounts of capital each year because of defaults; there will be a fairly large write-off this financial year, which we are just about to report—then we would not have funds to reinvest, and is that value for the taxpayer?

[198] **Peter Black:** You are saying that other European organisations do not operate on the same basis.

[199] **Mr Johnson:** Sorry, I did not catch that.

[200] **Peter Black:** You are saying that other European organisations—comparable ones to yours—do not operate on the same basis.

[201] **Mr Johnson:** I cannot comment; I do not know.

[202] **Mr Rowlands:** We have been independently reviewed in terms of our management of the JEREMIE funds, have we not?

[203] **Mr Johnson:** Yes.

[204] **Mr Wright:** Certainly in the UK, all the other JEREMIE funds that operate in the UK operate on the same basis, that is, with similar rates to us. I think that one of the responses to the access to finance review came from the North West Fund. I would also say, with regard to European organisations, that I think that the European guidelines state that the financial intermediary, which is ourselves, the fund manager, should pass on the advantage that it receives from the state to the final beneficiary, that is, the SME—going back to this issue of costing—in the form of either lower interest rates, or reduced collateral requirements, or a combination of the two, so that the business, that is, the final beneficiary, would be in a risk class where the intermediary would not invest, that is, it is deemed too high risk. So, this is where we go back—. We operate at a 10% acceptance of a default. That goes back to the point that you have a choice, in a way: do you bring the interest rates down, and then have a lower risk profile, or—. Our approach has always been that we would much rather widen the funnel and deal with the businesses that have been turned down elsewhere. It goes back to the point that Ian made about there is, therefore, money that is recycled, as it were, for future SMEs as well.

[205] **Mr Rowlands:** Peter, we also have external sources of capital to satisfy, in terms of Barclays—

[206] **Mr Wright:** Yes, of course.

[207] **Peter Black:** Yes, I understand that. However, your argument, basically, is that, in

those 30% of cases, the reason why the interest rate is higher is because you feel that that is collateral requirements—

[208] **Mr Wright:** That could be the case—

[209] **Mr Rowlands:** I think that it goes back to my answer earlier—[*Inaudible*.]—risk based.

[210] **Peter Black:** Okay. Going back to 2008, when we had the major banking crisis, shortly after that, most of the central banks reduced their base rates to record levels. However, the access to finance review highlighted the fact that interest rates charged by Finance Wales remained at high levels after 2008. What was the reason for that?

10:30

[211] **Mr Wright:** I think there is a correlation with why the central banks reduced their interest rates to the low level they did. They did that because the economy had suddenly nosedived. One of the consequences of a nosediving economy is that more businesses fail. All the statistics prove that. Therefore, the rate of business failure goes up and, therefore, the risk in a flat-lining economy is much higher. So you have almost the counter effect: while the central bank artificially rules interest rates as low as it can do, the overall risk paradigm, if I can call it that, is higher. It does not equate exactly, but that is one of the main reasons for that. It is about the fact that you are either pricing for the risk—. Clearly, hopefully, as we now come out of the dark days since 2008, business confidence will increase and the business failure rate will subside.

[212] **Jocelyn Davies:** Mike, is your question on this point?

[213] **Mike Hedges:** On this very point, have not borrowing rates lost contact with the base rate? Traditionally, they were 2% or 3% above the base rate. We now have borrowing rates that are all considerably above the base rate. The old 2% or 3% above the base rate seems to have disappeared and risk seems to have become much more important. Have I got that right?

[214] **Mr Rowlands:** Yes.

[215] **Jocelyn Davies:** Why is that you always just say ‘yes’ to Mike? [*Laughter*.] You do not need to expand on it. Peter, shall we come back to you?

[216] **Peter Black:** It has also been noted that, for the enterprise zones in Wales, you are offering rates at 2% lower than elsewhere. How was that decision reached? Is that related to risk?

[217] **Mr Wright:** Yes it is, largely. I think that members of the committee were at Milford Haven at the same time as when I was there. My conversations earlier that day with Nick Bourne as the chair of the Haven Waterway enterprise zone were about what Finance Wales could do to support the enterprise zone initiative. That was when the decision was made—on that day, in fact. I said, ‘Actually, you are getting rate relief and capital allowance relief. There is not a massive arrangement. Perhaps there is something we can do about interest rates’. I went away and we came up with the 2% reduction—

[218] **Ms Jones:** It is on the basis that the businesses are lower risk because of the additional support that is available to them in the enterprise zones.

[219] **Peter Black:** Right, so that is a commercial decision based upon an analysis of the risk given the other advantages they have there.

[220] **Mr Wright:** Yes.

[221] **Peter Black:** In terms of your policy on seeking collateral and personal guarantees on loans, we have touched on that quite a lot. Has that policy changed recently or has that been a consistent policy?

[222] **Mr Wright:** That has been consistent over the years—

[223] **Mr Rowlands:** It has been consistent since I have been chairman of investment committee.

[224] **Peter Black:** So, do you initially seek personal guarantees or is that a last resort?

[225] **Mr Wright:** It would depend on how much cash capital the owners of the business, the management team, put in. If they had actually re-mortgaged their house to put money in already, then fine. It is about the balance. It is about whether we are taking all the risk. Sometimes, particularly with house prices having dropped, people are unable to do that. Therefore, we might take that personal guarantee in lieu of any cash contribution coming into the business from that point. That is generally when we use it.

[226] **Peter Black:** Moving on to my final question, how have your arrangement fees, charges and other loan terms been set?

[227] **Mr Wright:** Usually, we have what we call a pricing strategy review, which follows our investment strategy, when we look at what rates are in the marketplace. That is probably the principal thing we look at: where our rates are relative to other financial institutions and intermediaries, the banks, et cetera, in the market.

[228] **Peter Black:** So you benchmark those against other providers.

[229] **Mr Wright:** Absolutely. These days, quite often, as the access to finance review found, it is difficult to get hard data out of the banks. However, one of the benefits of having these online platforms, such as Funding Circle, is that they publish their rates very clearly on their websites. So, for example, Funding Circle's rates for its top-rated loans are about 8%. That is for an A loan. It goes down to a C loan, where it says that, typically, the rates are around 13%.

[230] **Ms Jones:** And the arrangement fees are higher than we would typically charge.

[231] **Mr Wright:** Yes, they would typically charge 4% to 5% arrangement fees.

[232] **Peter Black:** So, do you charge a lower arrangement fee?

[233] **Mr Wright:** For a loan, we would typically charge 1%. For an equity investment, we would charge probably 2% because there is more work involved in making that assessment. The review of interest rates picked up the point about different arrangement fee rates charged. So, it goes back to how we position ourselves in the market. The other thing that I would say relative to rates is that our interest rates are fixed for the full period to help an SME budget. So, in a way, when looking at movements in interest rates, you will clearly see that interest rates have been static, pretty much, over the last five years. Where interest rates will go depends on which economist you listen to. Some of the rates that are often quoted are actually variable, and go back, as you were saying, Mike, to a percentage over-base rate or whatever. However, we do that, and we have always done that, because it makes it easier for the SME to budget, which is one of their key requirements, usually.

[234] **Peter Black:** Okay, I try not to listen to economists, but that is fine.

[235] **Jocelyn Davies:** We have our own. [*Laughter.*] Have you finished now, Peter?

[236] **Peter Black:** Yes.

[237] **Jocelyn Davies:** Paul, we will have your question.

[238] **Paul Davies:** I will ask you some questions around the interest rates, because in one of the papers that we have received from you, you say, with regard to interest rates, that

[239] 'the current investing funds operate under contractual obligations with very different State Aid arrangements which cannot be unilaterally changed without reference to the Commission.'

[240] I just want to try to understand how then you can vary your interest rate, and what flexibility do you have to vary your interest rates without referring back to the Commission.

[241] **Mr Wright:** The rationale for the rates relate to the EIB, particularly, and the other backers in the funds, because all of the models were set up on a specific basis. If you were to vary the interest rate—. One of the things we did with the JEREMIE fund, to make sure that it had the maximum flexibility, was a formal state aid notification. You have choices. You can operate state aid under what is called the general block exemption regulations, which are, basically, an off-the-shelf set of regulations. However, they are quite limiting, because they are, by their nature, off the shelf. Therefore, as Sian said earlier, we would have not been able to invest higher than £1 million, and there would be a number of restrictions. So, we did a formal state aid notification, which linked our rates. We were asked, 'What rates are you going to charge?', and we replied that we would align them with the reference rate et cetera. We had a discussion earlier around that. So, if we were to move away to do, as was suggested, subsidised interest rates, we would be contravening that state aid notification, and we would have to go back to the Commission to do a variation. Unfortunately, the commission typically takes six to 12 months to respond to these things. However, it is something that we could look at for future funds, which will not have already had that state aid notification applying to them.

[242] **Ms Jones:** The other point to note is that when we model the funds at the outset, before we have an investor, we make an assumption about the average interest rate that we will lever from the investments. It is on that basis, when they can see that they will get their return, that they make the offer of commercial finance. So, we have scope to vary within that, because it is an average, rather than an absolute, and that means that we can operate a range of interest rates within that fund model.

[243] **Paul Davies:** So, you have some flexibility.

[244] **Ms Jones:** We have some flexibility within the funds, but once we get to a point where we are putting that average, if you like, and our ability to repay the external funders at risk, that makes life somewhat difficult.

[245] **Paul Davies:** Are there different state aid considerations for each fund that you manage?

[246] **Mr Wright:** Yes. For example, the Wales SME fund, which followed, and which was the fund that allowed us to go into the business-to-consumer area and those sorts of areas, operates under what is called the MEIP, the market economic investor principle, which means

that you have to always be investigating, and then you get the same rate or higher than what the market is.

[247] **Paul Davies:** When deciding interest rates, what consultation do you carry out with WEFO and the Welsh Government?

[248] **Ms Jones:** Do you mean on individual investments?

[249] **Paul Davies:** Yes.

[250] **Ms Jones:** Not at all. The investment decisions are made independently. On individual funds, that discussion is one that is had at the outset, and it is, broadly speaking, about the average interest rate that we need to charge in order to get back to where we started. It is not something that we review with them on a regular basis, because, as I say, generally, it is assumed at the outset.

[251] **Paul Davies:** What are the risks or restrictions faced by you if you do use state aid exemptions to offer lower interest rates?

[252] **Mr Wright:** The way that it can be done is if you have a separate pot of money made available. The fund would charge the same interest rate, but, in practice, what could happen—and I have seen this happen in some parts, and it has happened on one or two specific transactions—is for the Welsh Government to offer to actually effectively provide a rebate on that interest rate separately to the company. You can generally do that on what is called a de minimis basis, which allows you to go up to €200,000, and you would only apply that to the differential. The slight problem with de minimis is that it covers a lot of other things; so, some grants that are made available are also—. It is also cumulative, so you need to be quite careful, and the SME has to track where it is fitting de minimis from a range of sources. So, it is flexible to all that could be done. We were having some discussions yesterday at the board around whether the Welsh Government would want to try to do that at some stage, particularly around future funds, possibly.

[253] **Ms Jones:** Was your question around the risks associated with operating?

[254] **Paul Davies:** Yes.

[255] **Ms Jones:** In extreme sets of circumstances, if someone cried foul that we were offering illegal aid to a company, that would bring the whole deck of cards down. We could immediately be put on stop by the Commission for all of our activity, not just in terms of that single investment. The other issue is that if the Commission was to find that the aid was illegal, the obligation to repay is on the SME and not on Finance Wales. So, we would be told to go to recover those funds from the company. So, just to make the point, the shutdown scenario is the worst-case scenario. Those are the risks that we have to balance all of the time.

[256] **Jocelyn Davies:** We will come to your questions now, Chris.

[257] **Christine Chapman:** I just want to explore how the revenue that you receive is actually used by you. First of all, could you clarify what the main sources of revenue for Finance Wales are, and obviously the funds that that revenue administers?

[258] **Ms Jones:** I will start with the revenue point because each of the funds is funded slightly differently. In terms of revenue, we receive grant in aid, which I am sure is familiar to you, from the Welsh Government every year to cover some of our overhead costs, and to cover things like the regional offices and the xénos, the Wales Business Angels Network, and things that are not generally able to lever fees for the activities. The balance of our revenue

comes from our fund management activity and fees charged for managing funds in Wales, which pay for large parts of our operating costs.

[259] **Christine Chapman:** Going back to what the Welsh Government gives you, has it actually set a target for how the grant support will be reduced?

[260] **Ms Jones:** No.

[261] **Mr Johnson:** No.

[262] **Christine Chapman:** That has not happened yet.

[263] **Ms Jones:** No.

[264] **Mr Johnson:** We provide a figure in our budget that we provide every year to the Welsh Government, and that has gone down, certainly since I have been on the board, from around £5.1 million in 2008 to the current projected £2.5 million. So, we have halved the grant in aid, and that has been as a direct result of achieving fund management fees.

[265] **Ms Jones:** And economies of scale—

[266] **Mr Johnson:** Yes, and economies of scale.

[267] **Ms Lloyd Jones:** As we grow in terms of the funds under management, it is relatively easy for us to add on another fund and not have to create a whole new finance team or a whole new marketing team to support that. There was a planned cut in our grant in aid budget in 2008-9, which I suppose is a target. We were told that it would reduce by £0.5 million in one year and £0.5 million in the following year; so, we had to work to make sure that we could operate within those confines.

[268] **Christine Chapman:** Going back to the administration costs, what proportion is available? Could you say something about the proportion of your fund that is for administration?

[269] **Mr Wright:** The typical fund management fees that we charge the funds—they come from the funds directly—are typically around 2% overall. So, there are those fees. Across the various funds, that covers the fund management costs, and part of that covers the finance and the centralised sort of back-office functions from that point of view. In total, the fund management is where the people are out doing deals at the front end. That is all fully covered from those fund management fees, which the fund bears. The grant in aid covers some of the back-office costs, but they are not necessarily met for that. So, there is probably a total of around £4 million, or something of that order, which covers the back-office costs, the IT infrastructure and everything that is set into that.

10:45

[270] **Christine Chapman:** I would like to move on to another area, namely interest rates. At what interest rates is Finance Wales borrowing money?

[271] **Mr Wright:** The margin that we pay on the JEREMIE fund, which the EIB loans, is 1.8% over the EIB’s own equivalent of LIBOR, the London interbank offered rate. It works out, generally, that our overall costs—adding the other costs that go with that—add up to around 3.2% in total, altogether. That is on that element of the JEREMIE fund, which is 50%. I believe that, in the professor’s report, he talked about a cost of capital of 1.6%, which, going back to the point made earlier, is the difference between there being no cost of capital on the

European money. It is done like that. That was set when we took out the JEREMIE loan in 2009. By way of comparison, the rate that we pay to Barclays—and we have not drawn on that facility yet, but we will shortly—is double the margin. That reflects the higher interest rates that are available in the market. So, we pay twice that margin.

[272] **Jocelyn Davies:** Julie, shall we move on to your questions?

[273] **Julie Morgan:** I wanted to ask some questions about the way in which the performance of Finance Wales is defined and measured. So, how is the performance of Finance Wales measured?

[274] **Mr Johnson:** Well, initially, the board holds the management to account for the budget. We set a budget for the year and we monitor the management's performance against that budget. Externally—or sort of externally—the Minister and I sit down and look at the overall performance of the business and decide what the priorities might be for the coming year. Broadly speaking, that is how Finance Wales is monitored.

[275] **Mr Rowlands:** The monthly management information that we get as board members would include a range of key performance indicators, including investment activity against our budget for the year across the various funds and across the various types of investing that we do. It would also include things like default rates, arrears rates, and other detailed indicators of the underlying portfolio performance. It would include job creation and job retention levels against our forecasts for the year and so on. There is quite a detailed suite of KPIs that the business adopts each year, which we sign off and then monitor against.

[276] **Ms Jones:** I am sorry to harp on, but for each of the individual funds, the key performance indicators are set at the outset. So, using the microloan fund as an example, we make a proposal and say, 'From £6 million, we expect to make x number of investments, create x number of jobs and help x number of SMEs'. For some of the other funds, the indicators might relate to the number of patents filed, for example, in the technology side of the business. Those are set at the outset and are then projected over a five-year period, usually.

[277] **Julie Morgan:** So, for each fund, you would have specific performance indicators that you would then measure at intervals.

[278] **Ms Jones:** Yes. They are recorded monthly and reported quarterly to the relevant stakeholders or investors.

[279] **Julie Morgan:** You mentioned job creation; one of the things that Professor Dylan Jones-Evans criticised was the number of jobs created. Could you respond to that?

[280] **Mr Rowlands:** I do not know what figures he was citing in his review.

[281] **Julie Morgan:** Could you tell us about your record on job creation?

[282] **Ms Jones:** Overall, the record on job creation is very good. The area where we have been less successful against the target is on the Wales JEREMIE fund. As we mentioned earlier, the Wales JEREMIE fund was established before the banking crisis and before the economic crisis, so with the benefit of that wonderful thing, hindsight, the targets were overly ambitious. The other difference with the JEREMIE fund compared with the previous funds is that we are reporting actual jobs rather than planned jobs. In previous funds supported by Objective 1 and Objective 2, what we were counting was the planned jobs rather than the actual jobs. I do not think that anybody had factored that in when we made our estimate of what the job creation target would look like for the JEREMIE fund. It was a double whammy

really. The basis on which the target was set probably did not take account of all the factors, and then we had the financial and economic downturn and job retention has been as important as job creation.

[283] **Jocelyn Davies:** Mike, did you want to come in on this point?

[284] **Mike Hedges:** Very briefly—

[285] **Jocelyn Davies:** I know that the answer is going to be brief. [*Laughter.*]

[286] **Mike Hedges:** Not necessarily. Is it not one of the problems that if you put in a substantial investment, some of it increases productivity, so that you make the business more likely to succeed, but you may not necessarily generate more jobs?

[287] **Ms Jones:** Shall we all say 'yes'? [*Laughter.*]

[288] **Jocelyn Davies:** Yes. Thank you.

[289] **Mr Rowlands:** I would say that, in some cases, you are absolutely right, but not in all cases. If you take, for instance, the early-stage portfolio of technology-related investments, their job creation in the first few years—frankly, it can be five years—is quite modest. They are good profile jobs, if I may put it like that, in that they are scientific jobs and research jobs, but it is not until they start to commercialise, go to markets and start getting revenue that you see a dramatic expansion in job creation and job count. Some of these situations have long gestation periods before we can say that we helped that business to a situation where it is now employing 100 people, where five years ago it employed 10. So, it is mixed.

[290] **Mr Johnson:** The company moves out of research and development into production.

[291] **Jocelyn Davies:** Okay. Julie, shall we come back to you?

[292] **Julie Morgan:** I would like to go back to the JEREMIE fund. I think that the BBC reported that only 20% of its job creation target was reached. Would you say that that was correct?

[293] **Ms Jones:** I do not know which figures they were referring to.

[294] **Julie Morgan:** You do not know the background to the figures.

[295] **Ms Jones:** We know that we are behind target on the JEREMIE fund, but we are a long way—

[296] **Jocelyn Davies:** Do you think that you are 80% behind? No.

[297] **Ms Jones:** No, but we are also a long way from arriving at the point where we stop counting. Again, if you imagine that the JEREMIE fund started investing in August 2009, we did not count any jobs at all until after the anniversary of the first investments. We were counting actual jobs in 2010, so there is quite a lag between setting the target and scoring the first runs on the board. We will be counting those jobs for the next five years.

[298] **Julie Morgan:** One of the things is that, in Wales, we lack company headquarters. Small firms that prosper tend to sell out to multinationals. Have you been able to do anything to halt that pattern? Is that a key part of what you do?

[299] **Mr Rowlands:** Yes, a current initiative promoted by Finance Wales to the

Government is that we develop, as soon as possible, a fund for financing succession. Many people see the concept of a management buy-out as some sort of evil incarnation of something, but all that does is to retain control of the business in Wales. I think that it is a very positive contributor to the economy, as an alternative to selling the business to US incorporated and disappearing to the beach in Barbados for the rest of your life. We are absolutely trying to stimulate, if I can call it this, the recycling of ownership within Wales, to retain it within Wales.

[300] The second theme that we are developing is to finance those who do succeed. If we cannot stop them—and arguably why would we be able to stop them—selling their business in a successful environment, or perhaps listing it on a stock exchange, we need to make sure that we keep hold of those successful entrepreneurs to do it again, here, in Wales.

[301] **Ms Jones:** One of the conditions for funding by Finance Wales is that you stay here and that when you move out, you have to repay. That is not a weapon, but it is a bit of a tool in terms of being able to help to sustain businesses and keep them here.

[302] **Julie Morgan:** Would you say that you have been successful in doing that?

[303] **Mr Rowlands:** It is too early to talk about any success in that regard.

[304] **Ms Jones:** Bearing in mind that we are dealing with SMEs, it is not as though we are investing in large corporates and that sort of thing, so these—.

[305] **Mr Rowlands:** To put it in context, we are typically involved in the sale of a business at the rate of about two or maybe three a year. So, it is not a stampede off-stage at all. It is a pretty modest rate of turnover, but even so we want, for the reasons you raise in your question, to do all that we can to recycle the ownership of those businesses locally.

[306] **Julie Morgan:** Thank you. My last question is: how are salaries and benefits at Finance Wales set?

[307] **Mr Johnson:** Maybe I can answer that. The board, ultimately, but—

[308] **Julie Morgan:** The board sets them.

[309] **Mr Johnson:** Yes, but the board has a remuneration committee of independent directors that takes account of benchmarking. We currently have a review under way that is looking at pay and remuneration for management. So, it takes that into account and it makes recommendations to the board and the board approves the remuneration each year. That remuneration package is set in, and established in, the annual report that goes to the Welsh Government for sign-off.

[310] **Julie Morgan:** Is there any performance-related pay?

[311] **Ms Jones:** It is all performance related.

[312] **Julie Morgan:** Pardon?

[313] **Ms Jones:** All our pay is performance related. We moved in 2007-08, I think, to a total review of terms and conditions within the organisation, which included remuneration, but also included things like flexi time, annual leave and so on. We moved everybody on to new contracts, so that everybody was employed on the same terms and conditions, and we moved away from things like annual increments or automatic annual increments to a performance- related pay regime.

[314] **Peter Black:** Is that more bonuses?

[315] **Ms Jones:** Yes.

[316] **Peter Black:** I see.

[317] **Jocelyn Davies:** There are no zero-hours contracts amongst any of that, are there?

[318] **Ms Jones:** No.

[319] **Jocelyn Davies:** Chris, do you want to come in?

[320] **Christine Chapman:** I am not sure whether you will be able to answer this, but on performance-related pay, are you able to tell us the percentage of staff that are underperforming? That might be a difficult question to answer, but bear in mind the criticism that you have come under.

[321] **Mr Johnson:** Did you say 'underperforming'?

[322] **Christine Chapman:** Yes.

[323] **Mike Hedges:** And therefore not generating performance-related pay.

[324] **Ms Jones:** Typically, if I use 100 as the number—we have slightly more staff than that currently—I would say that, every year, somewhere between 5% and 10% of staff end up being in the 'improvement required' category. If they do it more than a couple of times, they are often not with us for very much longer.

[325] **Jocelyn Davies:** So, you have a vigorous system for reviewing the performance of staff, apart from performance-related pay by the sound of it. I know that we have just a minute or two left, but there are just some things that I would like to cover. If you could make changes to the existing model that you have, what would be the most benefit?

[326] **Mr Johnson:** If we could make changes, what would—

[327] **Jocelyn Davies:** Yes. If you could make changes to your existing business model that you believe would be the most benefit, what would they be?

[328] **Mr Johnson:** I do not think that we really feel that we need to make many changes to the actual business model. It is working, it is on remit and we are filling the gap.

[329] **Ms Jones:** It has also proved to be quite flexible. Using the existing structures and the existing model, we were able, for the housing and regeneration department, to set up the Help to Buy-Wales scheme at very short notice. We did that within about three months and it has been operating since January. That is a very different marketplace, if you like, from the one that we are accustomed to working in, in terms of investing. However, in terms of establishing models for providing finance for different types of individuals or people, then we have the skills to set those things up and we have recruited people to run it.

[330] **Jocelyn Davies:** We heard a little bit about non-traditional financing. Are you able to facilitate that?

[331] **Mr Johnson:** Do you mean crowd funding and things like that?

[332] **Jocelyn Davies:** Yes.

[333] **Mr Johnson:** We are actually looking at that right now.

[334] **Mr Wright:** We have a meeting this afternoon on that topic. We had an initial scoping report commissioned last November—

[335] **Ms Jones:** It was October.

[336] **Mr Wright:** It was October.

[337] **Jocelyn Davies:** So, it might be for you or it might not; it is early days yet in terms of whether you will be going into that.

[338] **Mr Wright:** My personal view, and I am a bit of a campaigner for this in Finance Wales, is 'absolutely'. The rate that that market is growing—

[339] **Mr Rowlands:** It is something that we looked at specifically in the Breedon review. We cannot be King Canute about this; it is with us and so I think it is a question of Finance Wales working out how it can absorb and adopt that proposition as part of its suite of activity. We have three new funds that are going to be launched—two this year and one next—to address very specific areas of market failure. So, in that sense, our operating model is constantly under refresh.

11:00

[340] **Ms Jones:** We also have potential British business bank funding coming through this year, if that is successful. We also have xénos, the Wales Business Angel Network as a subsidiary of Finance Wales, which is located in the same building, so we are able to work closely with it with a different groups of investors.

[341] **Mr Rowlands:** And we are working, Sian, with Business Wales.

[342] **Jocelyn Davies:** We have finished just one minute late, so that is pretty good. We have run out of questions and time at the same time, which is always good. I think you said that you would send us a note on the level of loan write off. You said what percentage it was, but we wondered how much that was in money. Thank you for coming today. We will send you a transcript; if you can have a look at that for factual accuracy before we publish it in final form, we would be very grateful.

Cynnig o dan Reol Sefydlog 17.42 i Benderfynu Gwahardd y Cyhoedd
Motion under Standing Order 17.42 to Resolve to Exclude the Public

[343] **Jocelyn Davies:** I move that

the committee resolves to exclude the public from the remainder of the meeting and the first item of the next meeting in accordance with Standing Order No. 17.42 (vi) and (ix).

[344] I see that the committee is in agreement.

Derbyniwyd y cynnig.
Motion agreed.

Daeth rhan gyhoeddus y cyfarfod i ben am 11:01.
The public part of the meeting ended at 11:01.