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DEVELOPMENT BANK OF WALES

Development Bank of Wales's response to the Finance Committee inquiry into the Welsh Government's capital funding sources.

1. The Development Bank of Wales's mission is to unlock potential in the economy of Wales by increasing the provision of sustainable, effective finance in the market.
2. Development Bank of Wales supports Welsh businesses with Loans from £1,000 to £5million to start, strengthen or grow and Equity investment from £5,000 to £5million for established businesses. In recent years funds have been created to provide patient capital with loan terms up to 15 years.
3. In addition the Development Bank of Wales provides seed finance for pre-revenue tech start-ups and property development loans. It often co-invests alongside banks, crowd funders, grant providers, investors and other lenders. The 'gap funding' model means the Development Bank of Wales can work alongside other investors to make a deal happen by co-financing the element of the deal which is unattractive to the private sector due to the risk or lack of security.
4. With the exception of £10m funding from Clwyd Pension Fund, the Development Bank of Wales invests Welsh Government finance through a number of funds targeted at Welsh small to medium sized enterprises (SME). This is in the form of Welsh Government Core Capital, Financial Transaction Capital and the European Regional Development Fund (ERDF).
5. Historically a number of the funds managed by the Development Bank of Wales' predecessor, Finance Wales, were financed by loans from UK Banks and the European Investment Bank. This is no longer the case due to limitations on Government borrowing.

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ERDF
Llywodraeth Cymru
Welsh Government
Ewrop & Chymru: Buddsoddi yn eich dyfodol
Cronfa Datblygu Rhanbarthol Ewrop
Europe & Wales: Investing in your future
European Regional Development Fund

6. As finances come under increasing pressure it is important that wider funding sources from the private sector, pension funds and other players in Wales, including Local Government and the Social Sector, are considered. The Development Bank of Wales stands in a good place to work with multiple stakeholders to devise funding mechanisms that are co-ordinated and complementary to drive maximum impact for the Welsh pound.

Conventional Funding (including Financial Transaction Capital)

Welsh Government Core Capital

7. Very few Development Bank of Wales funds are financed using Core Capital. This is due to two factors. First is the reduction in availability of core capital resulting from UK level real term cuts to the Welsh Government block grant and the increased costs of delivering capital projects. The other main driver is the increase in availability of Financial Transaction Capital (FTC) in recent years. A percentage of FTC has to be repaid to HM Treasury so must be invested in projects or funds that can generate a financial return. The Development Bank of Wales is a natural choice for deploying FTC.
8. Traditionally the choice of whether to deploy grant or repayable finance has been a binary decision. However there are many instances where projects can become viable with only a small element of grant alongside access to commercial finance.
9. In recent years three funds have been created (the £40m Wales Stalled Sites Fund, £50m Wales Tourism Fund and £55m Wales Commercial Property Fund) which consist of Welsh Government core funding which is used to finance a Welsh Government managed grant element alongside FTC which is deployed as commercial finance by the Development Bank of Wales. For the three funds a total of £33m core capital (WG grant) will drive an initial investment of £145m in Welsh businesses. The impacts are further increased for funds like the Wales Stalled Sites Fund which, on its own, will be recycled to make up to £200m of investments through its life.
10. Returns made on Core Capital can be used by the Development Bank of Wales to recycle and reinvest or seed successor funds.
11. Recycling of funds can also dramatically increase the impact of the initial investment. A good example was the £10m Wales Property Development Fund launched in 2013, using Core Capital, which invested over £34million during its life and is on track to repay the Welsh Government its initial stake of £10m. Its successor fund, the £30million Wales Property Fund is, through recycling, forecast to invest up to £272million.

European Regional Investment Funds (ERDF)

12. One of the largest forms of funding for the Development Bank of Wales has been the EU financed ERDF. This is very similar to Welsh Government Core Capital in that it allows the Development Bank of Wales to create a legacy through returns which can be re invested in Welsh businesses.

13. It is estimated that £60m of legacy will be created by the Wales JEREMIE Fund and around £130m from the current fund; the Wales Business Fund. If these funds were to be followed by similar finance through the UK Shared Prosperity Fund, the Development Bank of Wales could build up sufficient reserves to become fully sustainable in its core mission to provide access to finance to Welsh SMEs.

Financial Transaction Capital (FTC)

14. The majority of new Funds created by the Development Bank of Wales have been financed using Financial Transaction Capital (FTC). To date the total FTC allocation to the Development Bank of Wales, including Help to Buy - Wales, totals around £820 million; this represents 80% of the total FTC which has been allocated to the Welsh Government.

15. The Development Bank of Wales is working closely across Government Departments to understand their challenges and help to develop products and services that will help them to deliver their programme for Government objectives.

Government Loans (including borrowing limits)

16. The recent increase in borrowing limits by Welsh Government is welcomed in the light of budgetary constraints. In its first eight years the predecessor to the Development Bank of Wales, Finance Wales, was mainly funded through borrowings. It cannot borrow now due to the restrictions on Government borrowing and there are no current plans to allot any of the Welsh Government's borrowing powers to finance funds operated by the Development Bank of Wales.

17. FTC is however a more cost effective means of financing certain funds managed by the Development Bank of Wales. If at some stage FTC were to be withdrawn as a form of funding for the Welsh Government it would be necessary to reconsider other forms of borrowing to support Development Bank of Wales investments.

Borrowing Powers of Welsh Government Bodies

18. The Development Bank of Wales does not currently have the powers to borrow. The 2009 Wales JEREMIE Fund was constructed with a proportion of loan capital from the European Investment Bank. The Wales JEREMIE Fund was the first to repay its loan in full to the European Investment Bank. The cost of the finance reduced the legacy that could be created by the fund and the fund itself was more complex to deliver due to the commercial arrangements with the lender.

19. Whilst the Welsh Government has FTC to administer it is difficult to see an advantage in external borrowing as this will be more expensive and less flexible. The only exception relates to equity funds where external finance would make delivery of such funds much easier due to State Aid rules around equity investment.

The Mutual Investment Model

20. The Development Bank of Wales is currently assisting the Welsh Government with aspects of the delivery of this new model of investment.

The financial risks and costs of borrowing for different funding models or for specific models.

21. The risks and costs of borrowing can result in the transfer of costs to the end beneficiary. As a development bank we invest where the private sector often will not due to the risks and costs involved. Development Bank of Wales manages this with investment comprising different funding sources and careful management of the investment portfolio.

22. Each new proposed fund is put forward using a detailed financial model and a 5 case business plan. Funds are then assessed throughout their lives through monthly and quarterly management information and independent reviews at key stages. Where a fund begins to underperform corrective action is taken quickly to rebalance the portfolio. Where new, innovative funds are created the Development Bank of Wales agrees review points with the funder when the fund performance is formally reviewed.

23. The funds currently operated by the Development Bank of Wales encompass a wide range from very high risk (early stage seed funding) to low risk (management succession funding). This diversification spreads the risk and costs on a portfolio basis rather than isolating risks and costs on a project by project basis. The Development Bank of Wales keeps a closely monitors the overall forecast returns on its FTC commitments. This helps to inform the risk appetite for future funds.

How funding sources could be used to deliver an effective capital funding strategy.

24. Funding sources can be used effectively through the Development Bank of Wales in the following ways:

25. Core funding and the replacement to EU ERDF (UK Shared Prosperity Fund) will create a legacy of funding which can reinvested. If this form of funding continues, over time the funds would become self-sustaining i.e. could be continued with little or no further investment from Government.

26. Use of Private sector finance alongside Government funds increases the impact per pound. The ‘gap funding’ model currently attracts an equal amount from the private sector thus doubling the impact. This increases further if the private sector invest alongside the Government at fund level as is the case with the £10m pension fund investment in the Management Succession Fund.

27. The use of Commercial finance alongside Government grant has the capacity to deliver far greater impact from reducing grant funding. The Wales Tourism Fund will deliver £50m investment from just £10m grant. The idea that the choice between grant and commercial finance is a binary decision needs to be challenged.

28. Recycling of funding is particularly important in the context of FTC. Rather than having a single short term fund, FTC and Core Capital can be used over a more extended period. Not all funds are candidates for recycling but the increase in impact for those that are suitable is substantial. A good example is the £30million Wales Property Fund which, through recycling, is forecast to invest up to £272million.

29. In delivering programmes for Wales, it is important to align with other funders such as Local Authorities and the Social Enterprise sector. There is potential for Central Government programmes to align its finances with Local Government initiatives to deliver greater impact.